IN THE

Supreme Court of the United States

October Term, 1977

No. A-1015
77-99

UTAH STATE UNIVERSITY OF AGRICULTURE AND APPLIED SCIENCE, *Petitioner*,

v.

BEAR, STEARNS & CO. et al., *Respondents*.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

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NOTE: The Appendices were not printed by the date this Petition must be filed. They will be presented separately later.

CITATIONS

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

This petition is filed on behalf of Utah State University of Agriculture and Applied Science ("the University"), appellant in each of eight companioned cases below.

The following list shows the respondent in each of the eight cases below by case number:

No. 75-1854 — Bear, Stearns & Co.
No. 75-1855 — Blyth Eastman Dillon & Co.
No. 75-1856 — Bosworth, Sullivan & Company
No. 75-1858 — Hornblower & Weeks — Hemphill, Noyes, Inc.
No. 75-1860 — Shearson, Hammil & Co.
No. 75-1861 — Sutro & Co.
Nos. 75-1862 — Merrill, Lynch, Pierce, Fenner & 75-1330 Smith, Inc.

The petitioner respectfully prays that a Writ of Certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Tenth Circuit entered in this proceeding on January 24, 1977, in all cases except No. 75-1861.

OPINIONS BELOW

The Opinion of the Court of Appeals has been published at 549 F. 2d 164 (1977). The opinion is set forth in Appendix A hereto.

The Opinion of the Court of Appeals (Appendix A) treats eight companioned appeals. Seven of those appeals (75-1854 to 75-1856, 75-1858 and 75-1860 to 75-1862) were from an order of the United States District Court for the District of Utah, Northern Division, dismissing the complaints in each of seven cases. The opinion of the District Court, treating all seven cases, is set forth in Appendix B hereto. That opinion has not been published in the official reports.

The eighth appeal treated by the Opinion of the Court of Appeals (76-1330) was from an order of the United States District Court for the District of Utah, Northern Division, dismissing the complaint in a separate case. The opinion of the District Court in that case is set forth in Appendix C hereto. Likewise, it has not been published in the official reports.

JURISDICTION

The judgment of the Court of Appeals for the Tenth Circuit was entered on January 24, 1977.

The University filed a petition for rehearing and suggested the rehearing be held *en banc*. The University's

petition was supported by a brief *amicus curiae* submitted by the Board of Governors of the Federal Reserve System.

On March 18, 1977, the Court of Appeals for the Tenth Circuit entered an order denying the University's petition for rehearing.

On June 3, 1977, this Court ordered that the time for filing a petition for writ of certiorari be extended to *July 18, 1977*.

This Court's jurisdiction is invoked under 28 U.S.C. § 1254 (1) (1970).

QUESTION PRESENTED

Whether illegal extensions of credit by a stockbroker in violation of Regulation T of the Federal Reserve Board (governing the extension of credit by brokers and dealers) give rise to private cause of action by a customer where the illegal extensions of credit occurred after the promulgation of Federal Reserve Board Regulation X (governing the obtaining of securities credit by borrowers).

STATUTES AND REGULATIONS INVOLVED

The Regulations being reviewed, Regulation T of the Federal Reserve Board, 12 C.F.R. Part 220 (Credit by Brokers and Dealers) and Regulation X of the Federal Reserve Board, 12 C.F.R. Part 224 (Rules Governing Borrowers Who Obtain Securities Credit), are set forth in relevant part in Appendix D hereto. The relevant provisions of Section 7 of the Securities and Exchange Act of 1934 (15 U.S.C. § 78g), under which Regulations T and X were promulgated, are set forth in Appendix E hereto.

STATEMENT OF THE CASE

This case involves whether a state university can maintain a private cause of action for damages against its stockbroker where the broker extended credit to it illegally.

The University purchased numerous orders of stock through each of the respondents ("the brokers"). The stock was to be delivered "C.O.D." to the University. In a number of orders placed with each broker, the stock was not delivered within 35 days of the purchase date as required by Federal Reserve Board Regulation T. The University did not pay for these orders until the stock was delivered — more than 35 days after the purchase date. The brokers, however, did not obtain leave to extend credit to the University beyond the 35-day period as envisioned by Regulation T nor did they cancel the orders as required by Regulation T. The stock declined in value between the time the brokers should have canceled the orders (the end of the 35-day period) and the time the brokers finally effected delivery and received payment.

Based on these facts, the University filed suit against each of the brokers contending that the brokers' violation of Regulation T gave rise to a private cause of action in its favor for damages.[1] The District Court granted motions to dismiss in all cases except one (No. 75-1862) and in that case granted the broker's motion for judgment on the pleadings. The Tenth Circuit affirmed, holding that "no private cause of action exists for violations of Regulation T."

Jurisdiction in the United States District Court of Utah was invoked under Section 27 of the Securities and Exchange Act of 1934 (15 U.S.C. § 78aa).

[1]Against one of the brokers, Merrill, Lynch, Pierce, Fenner and Smith, the University filed two suits. The second suit was filed some months after the first to cover separate violations of Regulation T not caught by the first complaint.

REASONS FOR GRANTING THE WRIT

I. THE TENTH CIRCUIT OPINION CONFLICTS WITH A SUBSTANTIAL BODY OF CASE LAW WHICH ALLOWS A PRIVATE CAUSE OF ACTION TO ENFORCE REGULATION T.

Section 7 of the Securities Exchange Act of 1934, 15 U.S.C. § 78g, relates to margin requirements. Subsection (a) declares its purpose to prevent "the excessive use of credit for the purchase or carrying of securities." Subsection (c) provides that it is unlawful for a broker "directly or indirectly, to extend or maintain credit . . . for any customer, (1) on any security . . . , in contravention of the rules and regulations which the Board of Governors of the Federal Reserve System shall prescribe . . . ." Regulation T was so prescribed. 12 C.F.R. Part 220. In essence it requires a broker to liquidate a customer's order if payment is not received within seven days from the date of purchase. If the customer in good faith agrees to make full cash payment upon delivery of the security, payment may be delayed until delivery which must take place within 35 days of the purchase. 12 C.F.R. § 220.4(c)(5).

Although Section 7(c) does not expressly provide a private cause of action for violation of Regulation T or any other regulations promulgated under it, numerous circuit courts have held that Section 7 and the regulations promulgated thereunder, including Regulations T and U,[2] may be the basis for a private civil action for damages or for rescission of a contract in violation of the regulations. *McCormick v. Esposito,* 500 F.2d 620 (5th Cir. 1974), *cert. denied* 420 U.S. 912 (1975), *Landry v. Hemphill, Noyes*

[2]Part 221 of 12 C.F.R. limits the amount of credit a bank may extend to a borrower for the purpose of purchasing securities. Known as Regulation U, its terms are similar to Regulation T.

& Co., 473 F.2d 365 (1st Cir. 1973), *cert. denied* 414 U.S. 1002 (1973), *reh. denied* 415 U.S. 960 (1974), *Naftalin & Co. v. Merrill Lynch*, 469 F.2d 1166 (8th Cir. 1972), *Goldman v. Bank of Commonwealth*, 467 F.2d 439 (6th Cir. 1972), *Pearlstein v. Scudder & German*, 429 F.2d 1136 (2d Cir. 1970), *cert. denied* 401 U.S. 1013 (1971), *Goldenberg v. Bache & Co.*, 270 F.2d 675 (5th Cir. 1959), *Jennings v. Boenning & Co.*, 388 F.Supp. 1294 (E.D. Pa. 1975), *aff'd.* 523 F.2d 889 (3d Cir. 1975). These courts have recognized that a private cause of action furthers the primary purpose of Section 7, which is "to prevent speculation on credit from draining a disproportionate share of the nation's credit resources into the stock market," *Naftalin, supra* at 1180. Some of them have also found that "A subsidiary purpose of § 7(c) [which makes it illegal to violate the rules and regulations promulgated pursuant to [§7] . . . is to protect the small investor from the dangers of excessive trading on credit" and that Regulation T furthers that purpose by "preventing the investor from engaging in speculative securities transactions which he could not, or would not, enter if the margin requirements were complied with," *Landry, supra* at 370. Thus, the primary basis for Section 7 civil actions is the implied remedy doctrine set out in *J. I. Case Co. v. Borak*, 377 U.S. 426, 432 (1964), in which the Court held that private actions may be a "necessary supplement to Commission action" in the enforcement of Section 14(a) of the Securities Exchange Act. This Court has recently reaffirmed the *Borak* doctrine in *Piper v. Chris Craft Industries, Inc.*, ... U.S. ...., 97 S. Ct. 926 (1977), *reh. denied* 97 S. Ct. 1668 (1977). See also *Cort v. Ash*, 422 U.S. 66, 82 (1975).

An additional basis is Section 29(b) of the Act, 15 U.S.C. § 78cc(b), which provides that any contract which violates the Act or regulations is void. This section has

been relied on in borrowers' actions to void a loan by a bank in contravention of Regulation U and in defense of the bank's claim to enforce the loan, see *Serzysko v. Chase Manhattan Bank*, 290 F.Supp. 74, 90 (S.D. N.Y. 1968), *aff'd. mem.* 409 F.2d 1360 (2d Cir. 1969), *cert. denied* 396 U.S. 904 (1969), *Stonehill v. Security Natl. Bank*, 68 F.R.D. 24 (S.D. N.Y. 1975).

A third basis relied on for implying a private cause of action is found in tort law. *Reader v. Hirsch & Co.*, 197 F. Supp. 111, 114 (S.D. N.Y. 1961), *Remar v. Clayton Securities Corporation*, 81 F. Supp. 1014 (D. Mass. 1949), *Appel v. Levine*, 85 F. Supp. 240 (S.D. N.Y. 1948). These cases reason that Section 7, at least in part, was intended to protect an individual like the plaintiff. Reliance is had on language in the House and Senate Reports on the Securities and Exchange Act of 1934 indicating that one of the intended effects of the margin provisions was to protect margin purchasers. H.R. Rep. No. 1383, 73rd Cong., 2d Sess. (1934) and S. Rep. No. 1139, 73rd Cong., 2d Sess. (1934).

Whatever the rationale followed: "The recent cases have been uniform in recognizing civil liability for violation of the margin requirements of Regulation T." *Avery v. Merrill Lynch, Pierce, Fenner & Smith*, 328 F. Supp. 677 (D.C. D.C. 1971).

In 1970 Congress amended the 1934 Act by adding § 7(f), 15 U.S.C. § 78g(f), which declares that it is illegal for any person to obtain, receive, or enjoy the extension of credit in connection with the purchase of securities contrary to the Federal Reserve System regulations. The Board of Governors of the Federal Reserve promulgated Regulation X, 12 C.F.R. Part 224, effective in 1971, which prohibits any borrower from "falsely," "willfully," or

"intentionally" obtaining credit in violation of Regulation T. 12 C.F.R. § 224.1. An innocent mistake made by a borrower in connection with the obtaining of credit is not a violation of Regulation X. 12 C.F.R. § 224.6(a).

Prior to these proceedings, the Tenth Circuit had never decided the question whether violations of Regulation T were the basis for civil liability. The Opinion below is not clear whether the Court merely refused to follow in the Tenth Circuit the great weight of authority allowing private causes of action to enforce Regulation T *quite apart from the 1970 amendment to Section 7*, or whether the Court's holding was based on the 1970 amendment and Regulation X promulgated under the amendment.[3] To the extent the Opinion was not based on the 1970 amendment to Section 7 and on Regulation X, the Tenth Circuit decision is clearly in conflict with square decisions of the First, Second, Third, Fifth, Sixth, and Eighth Circuits (see cases cited above) and should be reviewed by this Court.

To the extent that the opinion below holds that the additions of Section 7(f) and Regulation X eliminated *under all circumstances* a private cause of action based on broker margin violations, it is in conflict with a growing body of district court cases, at *least one of which* is before another Circuit on appeal, *McNeal v. Paine, Webber, Jackson & Curtis, Inc.*, 429 F. Supp. 359 (N.D. Ga. 1977), an opinion of Judge Edenfield on appeal to the Fifth Circuit, Docket No. 77-2033, holding that a private cause of action still lies to enforce Regulation T.[4]

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[3]In *Palmer v. Thomson & McKinnon Auchincloss, Inc.*, [1977] Fed. Secs. L. Rptr. (CCH) ¶ 96,000 (D. Conn. 1977), Judge Blumenfeld interpreted the Tenth Circuit decision as being a refusal to follow "the Second Circuit's ruling in *Pearlstein, supra*, presenting a direct conflict between Circuits.

[4]In addition counsel for defendant in *Palmer, supra*, advises the undersigned that an appeal of that case to the Second Circuit is likely to be taken within two months.

Where a district court decision in conflict with a court of appeals decision sought to be reviewed is pending on appeal to another court of appeals, and the petitioner seeking review of the court of appeals decision cannot delay his petition for *certiorari* until the other appeal has been decided, this Court has granted the petition. *Gulf States Steel v. United States*, 287 U.S. 32 (1932).

Other district court cases in conflict with the Opinion below are discussed hereinafter.

II. WHETHER CIVIL LIABILITY STILL LIES FOR BROKER VIOLATIONS OF MARGIN REQUIREMENTS, AND UNDER WHAT CIRCUMSTANCES, IS AN IMPORTANT QUESTION OF FEDERAL LAW WHICH HAS NOT BEEN, BUT SHOULD BE, SETTLED BY THIS COURT.

A. The Interpretation Placed by the Opinion Below on the Impact of Section 7(f) and Regulation X on Private Causes of Action for Violations of Regulation T is in Conflict With the Interpretation of the Federal Reserve Board.

This Court should review because the Opinion below is at odds with the consistent construction given Regulation X since its promulgation six years ago by the Federal Reserve Board. That the Board of Governors of the Federal Reserve Board submitted a brief *amicus curiae* in support of the University's petition for a rehearing to the Tenth Circuit indicates its disagreement with the Opinion. As that brief points out, in February, 1976, the Board of Governors published a manual entitled "Questions and Answers Illustrating Applications of Regulation U." Its preface states that the questions and answers have been prepared primarily for the benefit and guidance of banks. Under the heading *Liabilities for Violations* is Question No. 40 which states as follows:

> *Question.* —What are the potential liabilities of a bank or a borrower for violation of Regulation U?
> *Answer.* —As to the bank, Section 29(b) of the Securities Exchange Act of 1934 declares contracts made in violation of regulations issued thereunder void as to the rights of the violator. The party not responsible for the violation may rescind the contract and, in a proper case, sue for damages. Further, the bank may be criminally liable under various statutes, including those cited in the Form U-1 purpose statement, and as an aider and abetter of violations of Regulation X.
>
> A borrower may have criminal liability under various statutes, including those cited in the Form U-1 purpose statement, and under Regulation X.

Certainly this manual would not have indicated that a bank could be sued for damages or that a loan contract could be rescinded if it were thought that the private cause of action by a borrower had been totally eliminated.

As further noted by the Federal Reserve Board, the Form U-1 purpose statement which a bank is required to obtain from the borrower under section 221.3(a) of Regulation U contains the following warning at the top:

> A false or dishonest statement on this form may be punishable by fine or imprisonment (U.S. Code, Title 15, Section 78ff and Title 18, Sections 1001, 1005 and 1014). A borrower who falsely certifies the purpose of credit on this form or otherwise *willfully* or *intentionally* evades the provisions of Regulation U will also violate Federal Reserve Regulation X, "Rules Governing Borrowers Who Obtain Securities Credit." (emphasis added)

It is clear from this caveat that the Federal Reserve Board believes borrowers to be liable only for "intentional" and "willful" violations of Regulation X.

Since the Federal Reserve Board promulgated Regulation X, it is unlikely to accept the Tenth Circuit's view as conclusive. Since it is also charged with administration and enforcement of Regulation T, it is important that this Court settle the controversy. *Patterson v. Lamb,* 329 U.S. 539 (1947).

B. The Extent of the Impact of Regulation X Upon Regulation T is a Troublesome Question Involved in a Growing Body of Cases Pending in Lower Courts.

The complexity of fitting in Section 7(f) and Regulation X with the body of law allowing private enforcement of margin violations has been well understood by lower courts. As was stated by one:

> Reference to the recent amendments to [Section 7 of the 1934 Act] is futile. The act is a complexis. In the words of the board, 'Confusion hath now made this masterpiece.' "

Spoon v. Walston & Co., 345 F. Supp. 518, 521 (E.D. Mich. 1972) quoting Shakespeare, Macbeth, Act II, Scene II, *aff'd per curiam* 478 F.2d 246 (6th Cir. 1973). Although no case involving a direct conflict between Regulations T and X has been decided by another Circuit, district courts have decided a number of such cases *contra* to the Opinion below. *Palmer v. Thomson & McKinnon Auchincloss, Inc., supra,* (in which the court requested the Federal Reserve Board to file an *amicus* brief, then stated it had the "unenviable task" of determining to what extent, if any, cases allowing private enforcement of margin violators "had been undercut" by the addition of Section 7(f)), *Lantz v. Wedbush, Noble, Cook, Inc.,* 418 F. Supp. 653 (D. Alas. 1976), *Neill v. David A. Noyes & Company,* 416 F. Supp. 78 (N.D. Ill. 1976), *Newman v. Pershing & Co.,*

Inc., 412 F. Supp. 463 (S.D. N.Y. 1975). See also dicta in *Freeman v. Marine Midland Bank-New York*, 419 F. Supp. 440 (E.D. N.Y. 1976), and *Bell v. J. D. Winer & Co., Inc.*, 392 F. Supp. 646 (S.D. N.Y. 1975 While so far as can be ascertained, only *McNeal v. Paine, Webber, Jackson & Curtis, Inc., supra,* has been appealed to another Circuit, the plethora of recent district court cases which have held that private enforcement of Regulation T is still a viable doctrine, *contra* to the Tenth Circuit, make an early and definitive ruling by this Court desirable. *United States v. Standard Oil Co.*, 332 U.S. 301, 302, n.2 (1947).

The extent to which Regulation X affects private actions to enforce Regulation T has been the subject of numerous articles reaching, not surprisingly, widely differing conclusions. See, e.g. DeVita, *Civil Liability for Margin Voilations — the Effect of Section 7(f) and Regulation X*, 43 Fordham L. Rev. 93 (1974); Dowling, *In Pari Delicto as a Defense to Violations of Margin Legislation Under the Securities and Exchange Act of 1934*, 9 U.S.F.L. Rev. 113 (1974); Silbaugh, *Regulation X: A Complexis*, 50 Notre Dame Law. 136 (1974); *Regulation X and Investor-Lender Margin Violation Disputes*, 57 Minn. L. Rev. 208 (1972).

It is already evident that the Opinion below, instead of having a salutory effect on this nettlesome area, has only added to the confusion. Two district courts which have cited the Opinion have given it differing constructions. Judge Blumenfeld in the *Palmer* case, *supra,* read it as a refusal to adopt in the Tenth Circuit the position allowing private actions that almost every other Circuit had taken in cases arising prior to the 1970 amendment.

Judge Pollack in *Drasner v. Thomson McKinnon Securities, Inc.*, [1977] 409 Sec. Reg. & L. Rep. (BNA) A-7 (S.D. N.Y. June 6, 1977), read the Opinion as holding that the 1970 amendment abolished the private right of action in *every situation* ("the [Tenth Circuit] went the whole way and held that no private right of action exists for violations of Regulation T.")

As noted by a commentator: "The future of private actions under Regulation T can largely be forecast by the past. Courts were in little agreement then and it is unlikely there will be much uniformity in the future *unless the Supreme Court makes a definitive ruling.*" Silbaugh, *supra*, pp. 156-157. (Emphasis added.)

C. The Future of Enforcement of Federal Reserve Board Regulations T, U, and G Require a Prompt Decision on the Availability of Private Actions.

The Opinion has far reaching implications concerning the enforcement not only of Regulation T but also of Federal Reserve Board Regulation U, which governs the extension of credit by banks for the purpose of purchasing or carrying margin stocks and of Federal Reserve Board Regulation G, governing the extension of securities credit by persons other than banks, brokers or dealers. 12 C.F.R., Parts 221 and 207, respectively. For if Section 7(f) abolished private actions to enforce Regulation T, it also abolished private actions to enforce Regulations U and G. 12 C.F.R. § 224.2(a)(1) and (3). The Federal Reserve Board, the Securities and Exchange Commission, and Congress should know soon to what extent, if any, they can continue to rely on private enforcement of margin re-

quirements. As was recently noted in ***Palmer, supra:*** "Margin violations are in the nature of 'victimless crimes' which neither broker nor borrower is likely to report. The likelihood of administrative enforcement is therefore remote." It is well known that a lack of facilities and personnel prevents inspection of more than a fraction of the registered broker dealers each year by the SEC.[5] Thus it is not surprising that the dozens of margin violations in these seven cases involving over a million dollars of illegally extended credit have not resulted in any administrative action.

In *Borak,* this Court noted in a different context that due to lack of adequate SEC resources: "Private enforcement of the proxy rules provides a necessary supplement to Commission action." *Supra,* 432. Relying primarily on this rationale, courts have allowed private suitors for over 20 years to more or less bear the burden of enforcing margin requirements. Does Section 7(f) change all this? The House Report notes:

> Part of the reason why Section 7 was originally enacted in its present form may have been a concern over putting the small investor at risk as to whether his broker or lender was complying with the regulations. The amendment has been carefully drawn to avoid this result.[6]

From the foregoing, it seems plain that Congress did not intend to deprive all investors of a private cause of action for breach of the initial margin requirements. *Palmer, supra.* However, the Tenth Circuit, without men-

[5]A study for the Special House Subcommittee on Investigations reports that in May, 1970, the Commission's largest office had only ten inspectors for the 2,000 broker-dealers in its area. Inspections, which often occur three years apart, are not comprehensive enough to be effective. STAFF OF SPECIAL HOUSE SUBCOMMITTEE ON INVESTIGATIONS, 92d CONG., 1st SESS., REPORT ON REVIEW OF SEC RECORDS OF THE DEMISE OF SELECTED BROKER DEALERS (Comm. Print 1971).

[6]Report of the House Committee on Banking and Currency, H.R. Rep. No. 91-975, U. S. Code Cong. & Admin. News 1970, 91st Cong. 2d Sess. at 4409.

tioning this pertinent legislative history, appears to hold that Section 7(f) abolishes private enforcement in this area. This Court should now decide whether margin requirements now require another system or enforcement so that the authorities may make the appropriate adjustments.

D. These Companioned Cases Present a Ripe Opportunity to Determine the Extent, if any, to Which Section 7(f) has Eliminated Private Enforcement of Federal Reserve Board Regulations.

The Opinion below disposed of the University's Regulation T claims as a matter of law, affirming orders of the district court granting motions to dismiss for failure to state a claim for relief in seven cases and a motion for judgment on the pleadings in the eighth case (No. 75-1862). The Tenth Circuit expressly refrained from ruling on whether summary judgment for the brokers would have been proper. Thus there is no dispute as to facts. This Court has the opportunity to decide the threshold question whether Section 7 of the '34 Act gives rise to implied private rights of action to enforce Federal Reserve Board securities credit regulations and if so, the narrow question as to what extent Section 7(f) affects those rights. More particularly, this Court has the opportunity to decide whether Section 7(f) eliminates private enforcement of Regulation T (and U and G) in all circumstances, as was the clear holding of Judge Anderson in the District Court below (pp. 32A and 33A), or whether its effect was merely to "reinstate" the *in pari delicto* defense which had been disallowed in *Pearlstein, supra.*[7]

[7]Holding that Section 7(f) merely restores to the broker certain defenses based on comparative fault, such as *in pari delicto*, are *Palmer, supra*, at f.n.15, and *Lantz, supra.* Consistent with this view is the reasoning of Judge Tyler in *Bell, supra*, and the comments of the Second Circuit in *Pearlstein v. Scudder & German*, 527 F.2d 1141 (2d Cir. 1975) ("*Pearlstein II*") on its earlier decision ("*Pearlstein I*," *supra*).

Finally, there is no doubt that these respondents, including some of the largest brokers on Wall Street, will adequately present the industry view. On the other side, the Federal Reserve Board has already participated in th proceedings below and can be expected to participate in any proceedings before this Court in support of the continuing validity of private enforcement of its securities credit regulations.

CONCLUSION

The Opinion below is the first from a circuit court to grapple with a tough problem. District courts citing it have already placed different constructions upon it and, significantly, no district court has followed or even approved it while three cases have either disapproved or ignored it.[8] This Court should review, if not to resolve what Judge Edenfield in *Palmer, supra,* believed to be a square conflict with the *Pearlstein I* pre-1970 body of law, to resolve potential conflicts between circuits which surely will arise if the present pace of district court litigation in this area continues as it likely will. Moreover, the importance to the federal agencies charged with administering and enforcing securities credit regulations of knowing whether the Opinion below is merly an aberration or sounds the death knell for private enforcement clearly calls for authoritative pronouncement now.

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[8]The *Palmer, Drasner,* and *McNeal* cases, *supra.*

For all of these reasons, the Petition for Writ of Certiorari should be granted.

Respectfully submitted,

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Counsel for Petitioner

DATED: July 18, 1977

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APPENDIX A

FILED
JANUARY 24, 1977
HOWARD K. PHILLIPS, Clerk, United States Court of Appeals Tenth Circuit

PUBLISH

UNITED STATES COURT OF APPEALS
TENTH CIRCUIT

UTAH STATE UNIVERSITY OF AGRICULTURE AND APPLIED SCIENCE, *Plaintiff-Appellant,* v. BEAR, STEARNS & CO., et al., *Defendants-Appellees.*	Nos. 75-1854 75-1855 75-1856 75-1858 75-1860 75-1861 75-1862 and 76-1330

APPEALS FROM THE UNITED STATES DISTRICT COURT FOR THE DISTRICT OF UTAH
(D.C. Nos. NC-74-38 through NC-74-40, NC-74-42, NC-74-44 through NC-74-46 and NC-75-58)

David L. Wilkinson, Special Assistant Attorney General (Vernon B. Romney, Attorney General, was with him on the brief) for Plaintiff-Appellant.

Harold G. Christensen, Parker M. Nielson and Keith E. Taylor (Daniel M. Allred, Krege B. Christensen, Parsons, Behle & Latimer; Dawson, Nagel, Sherman & Howard; Worsley, Snow & Christensen; R. Brent Stephens, Craig G. Cook and Alan E. Walcher were with them on the briefs) for Defendants-Appellees.

Before McWILLIAMS, BREITENSTEIN and BARRETT, Circuit Judges.

BREITENSTEIN, Circuit Judge.

These eight companioned appeals are from judgments dismissing actions brought by plaintiff-appellant, Utah State University, against various brokers to recover losses sustained in securities transactions. The claims are based on alleged violations of certain statutes, administrative regulations, and rules of private organizations of securities dealers. We affirm.

Utah State University of Agriculture and Applied Science, USU, is a corporation existing under the constitution of the State of Utah and operates at Logan, Utah, as a land grant university. Defendants are all brokerage firms organized under the laws of various states other than Utah. Each defendant is a member of the New York Stock Exchange, NYSE, the American Stock Exchange, AMEX, and the National Association of Security Dealers, NASD. Jurisdiction is based on § 27 of the Securities Exchange Act of 1934, 15 U.S.C. § 78aa.

In furtherance of its securities investment program, the governing body of USU on January 20, 1972, adopted a resolution which said:

(1) USU "is authorized and empowered to open and maintain an account with any broker" who is a member of a major security exchange or of NASD.

(2) The authorization covers "the purchase, trade and sale, long or short, [of] * * * stocks, bonds and securities of every nature on margin or otherwise * * *."

(3) Two named officers, Broadbent and Catron, have power to act under the resolution for USU.

(4) "[T]his resolution shall be and remain in full force and effect until written notice of the revocation hereof shall be delivered to the brokers."

Between February, 1972, and March, 1973, Catron

opened accounts with numerous brokerage firms and purchased millions of dollars worth of securities. Catron, a well-educated man with business and accounting experience, had been a licensed securities salesman. He became the Controller of USU in July, 1970.

In the Spring of 1972, the Utah State Auditor's Office notified Catron that later in the year an audit would be made of the USU investment program. To improve the program's cash flow picture, Catron engaged in a series of transactions in which he sold stock through one broker and immediately repurchased the same stock utilizing another broker. By this operation he received immediate payment for the stock sold and did not have to pay for the stock bought until its delivery.

In December, 1972, an independent auditing firm employed by USU questioned the legality of the USU stock purchase program. In the same month local newspapers reported the belief of an assistant attorney general of Utah that the USU stock purchases were illegal. On December 4, 1972, USU instructed Catron to stop purchasing securities on its behalf. Catron did not stop the USU security transactions until March, 1973, when USU sent to each brokerage firm a written revocation of Catron's authority. On December 23, 1975, the Supreme Court of Utah held that USU did not have the power to purchase common stock with its public funds. See *First Equity Corporation of Florida v. Utah State University,* Utah, 544 P.2d 887.

In each of the eight appeals before us, USU is the plaintiff-appellant. The following list shows the defendant-appellee in each case:

No. 75-1854 — Bear, Stearns & Co.

No. 75-1855 — Blyth Eastman Dillon & Co.

No. 75-1856 — Bosworth, Sullivan & Company

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No. 75-1861 — Sutro & Co.

Nos. 75-1862 — Merrill Lynch, Pierce, Fenner &
76-1330 Smith, Inc.

USU sued the brokers to recover its losses on stocks purchased and sold and to recover the commissions paid to brokers on all stock transactions regardless of whether USU received a loss or gain. The complaint asserts federal law claims which may be grouped in three categories:

1 — Violations of fair practice and suitability rules of NYSE, AMEX, and NASD.

2 — Violations of § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and of Rule 10b-5, 17 C.F.R. § 24.10b-5, promulgated thereunder.

3 — Violations of Federal Reserve System Regulation T, 12 C.F.R. Part 220, promulgated pursuant to 15 U.S.C. § 78g(a)

The complaints also allege various pendent claims under state laws.

In the *Sutro* case no Regulation T claim is presented. The two appeals relating to *Merrill Lynch* will be discussed separately. All defendants except Merrill Lynch filed motions to dismiss the pertinent complaint.

By order, the court allowed the parties "to file affidavits and other supporting material" so that the motions to dismiss could be considered as motions for summary judgment under Rule 12(b), F.R.Civ.P. Many affidavits were filed on each side. The deposition of Catron was

presented. The court dismissed the counts based on the NASD, NYSE, and AMEX rules for failure to state a claim in that violations of exchange and association rules do not give rise to a private cause of action. With regard to the Rule 10b-5 claims the court held that violations of the NYSE, AMEX, and NASD suitability rules did not give rise to a Rule 10b-5 claim and hence, the complaint did not state a cause of action under Rule 10b-5.

As to the claims based on Regulation T, the court held that the regulation did not give rise to a private cause of action and hence failed to state a claim. The court also held that summary judgment was proper on the Regulation T claims because USU was *in pari delicto*. On the pendent claims, the court, in dismissing, noted the pendency of state court actions involving those claims. No questions are raised on these appeals regarding the dismissals of the pendent claims.

The NASD, NYSE, and AMEX Rules.

Article III, § 1, of the NASD Rules of Fair Practice requires a member to "observe high standards of commercial honor and just and equitable principles of trade." Section 2 of the same Article requires a member in recommending the purchase of a security to a customer to have reasonable grounds for believing that the security is suitable for the particular customer. This proscription is often called the "Suitability Rule."

NYSE Rule 405, called the Know-Your-Customer Rule, and the similar AMEX Rule 411 require that a member use "due diligence to learn the essential facts relative to every customer, order" or account.

The Securities Exhange Act of 1934 requires the registration of national securities associations and exchanges.

The rules of these self-regulatory bodies must be approved by the Securities and Exchange Commission, SEC. See 15 U.S.C. § 78o-3b and § 78f(b). The areas and concerns which the rules must cover are statutorily imposed. *Ibid.* SEC must approve any changes in the rules. 15 U.S.C. § 78s(b). SEC can "abrogate, add to and delete from" any of the self-regulatory rules in order to further the purposes of the Act. 15 U.S.C. § 78s(c). Brokers who are not members of NASD have similar rules imposed on them by SEC regulation. For example, forms of NASD's Rules of Fair Practice, Art III, §§ 1 and 2 which are involved in these appeals, are imposed on non-members by 17 C.F.R. §§ 240.15b10-2 and 240.15b10-3.

Colonial Realty Corporation v. Bache & Co., 2 Cir., 358 F.2d 178, *cert. denied* 385 U.S. 817, rejected an implied cause of private action for violation of Art. III, § 1, of the NASD rules. The court recognized that the Securities Exchange Act of 1934 did not specifically authorize actions for violation of private association rules. The court said that an implied cause of action could be established by the courts to effectuate the congressional purpose and federal policy behind the 1934 Act. In so holding, the court relied on *J. I. Case v. Borak,* 377 U.S. 426. The court in *Colonial Realty* said that it would recognize an implied cause of action where the rule violated; (1) amounted to a substitute for an SEC regulation, and (2) established an explicit duty unknown to the common law. 358 F.2d at 182.

Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 7 Cir., 410 F.2d 135, *cert. denied* 396 U.S. 838, recognized an implied cause of action under NYSE Rule 405. The court said that determination of whether violation of a rule is actionable depends on whether its design is "for the direct protection of investors" and said one of the functions of Rule 405 was the protection of the public. *Ibid.* at 142. Critics of the *Buttrey* decision have pointed out that Rule 405 was not promulgated to protect customers from shady brokers but rather to protect brokers from unscrupulous customers. This criticism has its basis in SEC, Report of Special Study of Securities Markets of the Securities and Exchange Commission, H.R. Doc. No. 95, 88th Cong. 1st Sess., pt. 1, at 316.

In *Buttrey* the court did not say that an alleged violation of Rule 405 was per se actionable. 358 F.2d at 142. The complaint there under consideration alleged fraudulent conversion of securities. The court said, *Ibid.* at 143, that "the facts alleged here are tantamount to fraud * * *, thus giving rise to a private civil damage action."

The district courts of the Tenth Circuit are split on whether an implied cause of action may be based on NASD or stock exchange rules. No implied cause of action is recognized in *Thompson v. Merrill Lynch, Pierce, Fenner & Smith, Inc.,* W.D.Okl., 401 F.Supp. 111, and in *Utah v. duPont Walston, Inc.,* D. Utah, CCH Fed. Sec. Rptr. ¶ 94,812 at p. 96,713. A contrary result is reached in *Geyer v. Paine, Webber, Jackson & Curtis, Inc.,* D.Wyo. 389 F.Supp. 678.

In *Ocrant v. Dean Witter & Company, Inc.,* 10 Cir., 502 F.2d 854, by way of dicta, and citing *Buttrey,* we recognized that "in an appropriate case, violations of exchange rules designed for customer protection might give rise to a private cause of action * * *." *Ibid.* at 858.

The statement in *Ocrant* is pertinent. In an appropriate case a rule violation may give rise to a private cause of action. At the same time there is good reason to limit the scope of potential liability of brokers for rule violations. The advantages of self-regulation in the securities field may not be denied. Self-regulation obviates need for a

more massive governmental bureaucracy and a detailed and rigid regulation of the entire securities field. See S.Rep. No. 1455, 75th Cong. 3d Sess., 3-5, and H.R.Rep. No. 2307, 75th Cong. 3d Sess. 4-5. See also *Silver v. New York Stock Exchange,* 373 U.S. 341, 352. For the system to work effectively, the self-regulatory bodies must be encouraged to take the initiative in exploring and formulating new rules to govern the conduct of their members. Such action is doubtful if the promulgation of every new rule has the potential of creating massive liability for the members.

No provision of the Securities Exchange Act creates and express civil remedy for violation of an exchange or association rule. In *Ernst & Ernst v. Hochfelder,* 425 U.S. 185, the Supreme Court rejected a private implied claim for violation of SEC Rule 10b-5. The Court said, *Ibid.* at 207, that: "In each instance that Congress created express civil liability in favor of purchasers or sellers of securities it clearly specified whether recovery was to be premised on knowing or intentional conduct, negligence, or entirely innocent mistake." With reference to Rule 10b-5, the Court said, *Ibid.* at 206, that: "There is no indication that Congress intended anyone to be made liable for such practices unless he acted other than in good faith."

Applying the statements of the Court to claims asserted under association and exchange rules, something more than mistake or negligence must be shown. The allegations of the complaints are that the stocks were too speculative for USU, did not have earnings records showing suitability for purchase by USU, the stocks were purchased in too great quantities, the stocks were too thinly traded, and the purchase of the stocks by USU was *ultra vires*. No complaint has an allegation of fraud or bad faith. The allegations, taken separately or together, are not tantamount to fraud.

The argument that the brokers are liable because they should have known that the stock purchases by USU were illegal under Utah law does not impress us. USU seeks to take advantage of its own wrongful acts. It would retain the profits which it has made and recover from the brokers the losses which it has sustained. An *ultra vires* act of an institutional customer may not be converted into a wrongful act of a broker.

The fact that the brokers did not foresee the decision of the Utah Supreme Court made three years after the transactions in question does not establish fraud, or conduct tantamount to fraud, on the part of the brokers.

The complaints show that USU had a large stock portfolio covering thousands of shares in many diverse companies. The stocks were bought and sold through numerous brokers. No claim is made of overreaching, misrepresentation, manipulation or deception. The allegations of unsuitability for an institutional investor such as USU do not establish a claim of fraud or of misconduct tantamount to fraud. We recognize that in an appropriate case there may be an implied cause of action for private redress for violation of association or exchange rules. None of the cases before us are within that category. The trial court properly dismissed the claims based on the NASD, NYSE, and AMEX rules.

Section 10b and Rule 10b-5.

The USU claims under § 10b of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and SEC Rule 10b-5, 17 C.F.R. § 240.10b-5, promulgated thereunder are based on its allegations of violations of the NASD, NYSE, and AMEX rules. *Ernst & Ernst v. Hochfelder,* 425 U.S. 185, holds that for a private cause of action to lie under § 10b or Rule 10b-5, there must be allegations of scienter-intent to deceive,

manipulate or defraud. None of the complaints plead scienter. A claim of violations of the NASD, NYSE, and AMEX rules does not take the place of the scienter requirement. Willful or intentional misconduct, or the equivalent thereof, is essential to recovery by USU under either the statute or the regulation. *Ibid.* at 201. In the absence of the needed allegations, *Hochfelder* applies and requires the dismissal of the § 10b and Rule 10b-5 claims.

Regulation T.

Section 7 of the Securities Exchange Act of 1934, 15 U.S.C. § 78g, relates to margin requirements. Subsection (a) declares its purpose to prevent "the excessive use of credit for the purchase or carrying of securities." Subsection (c) provides that it is unlawful for a broker "directly or indirectly, to extend or maintain credit * * * for any customer — (1) on any security * * *, in contravention of the rules and regulations which the Board of Governors of the Federal Reserve System shall prescribe * * *." Regulation T was so prescribed. 12 C.F.R. Part 220. In essence it requires a broker to liquidate a customer's order if payment is not received within seven days from the date of purchase. If the customer in good faith agrees to make full cash payment upon delivery of the security, payment may be delayed until delivery which must take place within 35 days of the purchase. 12 C.F.R. § 220.4(c)(5).

The complaints charge that all of the brokers except Sutro & Co. violated the regulation. The complaints have no allegation that USU ever complained to any broker because of delay in delivery and payment. The complaints say that USU maintained a cash account with each broker; that as to specific stocks payment was not made in 35 days; that the broker did not cancel the purchase or liquidate the transaction; and that specified stocks were sold at a loss.

The complaints show that some stocks delivered and paid for after the 35-day period had not been sold by USU. The complaints do not allege that any particular stock or stocks, if delivered and paid for within the 35-day period, could have been disposed of without loss. USU wants its money back on stocks which at some undisclosed time were sold at a loss. The sole basis for the USU claims is failure to liquidate the transaction when payment was not made within the Regulation T time limits.

Pearlstein v. Scudder & German, 2 Cir., 429 F.2d 1136, *cert. denied* 401 U.S. 1013, recognized an implied cause of action for a customer under Regulation T. The court said that knowing participation of the customer in the violation did not bar recovery because the statute made it illegal to extend credit but not to receive it. *Ibid* at 1141. One judge dissented saying that the purpose of the margin requirements was to protect the overall economy from excessive speculation and that the protection against a speculator extending himself too thinly was only a by-product. *Ibid.* at 1147. An implied cause of action under Regulation T was also recognized in *Spoon v. Walston & Co., Inc.,* 6 Cir., 478 F.2d 246, and *Landry v. Hemphill, Noyes & Co.,* 1 Cir., 473 F.2d 365, *cert. denied* 414 U.S. 1022.

In 1970 Congress amended the 1934 Act by adding § 7(f). 15 U.S.C. § 78g(f), which declares that it is illegal for any person to obtain, receive, or enjoy the extension of credit in connection with the purchase of securities contrary to the Federal Reserve System regulations. The Board of Governors of the Federal Reserve to implement the amendment promulgated Regulation X, 12 C.F.R. Part 224, which prohibits any person from obtaining credit when to do so would cause the creditor to violate Regulation T.

The primary purpose of the 1970 amendment was to promote the stability of the securities markets. See 2 U.S.

Code Cong. & Admin. News '70, 4409-4410. The responsibility for compliance with the margin requirements is now on the customer as well as the broker. *Pearlstein, Spoon, and Landry* all concerned transactions occurring before the effective date of Regulation X. The statement in *Pearlstein*, 429 F.2d at 1141, that "Congress has placed the responsibility for observing margins on the broker" no longer applies. When the *Pearlstein* case came back to the Second Circuit after remand, the court, after referring to the 1970 amendment and Regulation X, said in *Pearlstein v. Scudder & German*, 2 Cir., 527 F.2d 1141, 1145, n. 3.:

> "The effect of these developments is to cast doubt on the continuing validity of the rationale of our prior holding."

Two district court decisions discuss at some length the impact of Regulation X on Regulation T. They are *Bell v. J. D. Winer & Co., Inc.*, S.D.N.Y., 392 F.Supp. 646, and *Freeman v. Marine Midland Bank - New York*, E.D.N.Y., 419 F.Supp. 440. In *Bell* the legislative history of the statutes underlying the two regulations is presented at length and we need not repeat it here. On the facts presented, *Bell* rejected the private implied cause of action asserted under Regulation T. *Freeman* agrees with the reasoning in *Bell*, but allows the private cause of action because the events giving rise to the action occurred before the promulgation of Regulation X. *Neill v. David A. Noyes & Co.*, N.D.Ill., 416 F. Supp. 78, which recognizes a private claim under Regulation T, is not pertinent because the complaint alleged fraud and deceptive conduct. See also *Lantz v. Wedbush, Noble, Cooke, Inc.*, D. Alas., 418 F.Supp. 653, a decision pertaining to the defense of *in pari delicto*.

Under Regulation X, the broker is subject to criminal penalties and the customer is not, if the credit is obtained innocently and, if upon learning of the violation, he makes

payment. This difference in criminal penalties is no reason for imposing civil liability on the broker. The imposition of that liability places the customer in a "heads I win — tails you lose" position. If the stock goes up, he takes his profit. If it goes down, he recovers his loss from the broker. Congress imposed the margin requirements to protect the general economy, not to give the customer a free ride at the expense of the broker.

Because of our conclusion that no private cause of action exists for violations of Regulation T, it is not necessary for us to consider that alternative action of the trial court allowing summary judgment for the defendants on the Reguation T claims.

The Merrill Lynch Cases.

Nos. 75-1862 and 76-1330 are USU appeals from judgments in favor of Merrill Lynch. The situation is somewhat different from that presented and considered in the other six appeals. In the *Merrill Lynch* cases the State of Utah was named as a plaintiff in the complaint, but did not join in the notices of appeal.

The initial *Merrill Lynch* complaint differs from the others in that the claim is asserted that the facts alleged in the counts pertaining to the violations of the NASD, NYSE, and AMEX rules also violate Rule 10b-5. We have held that on the record presented, violation of the association and exchange rules do not give rise to a private cause of action. No different result is mandated by joining the rule violations with a Rule 10b-5 claim. It adds nothing to combine the allegations. The conclusory statement in this complaint that the violations of the exchange and association rules "operated as a fraud and deceit upon the plaintiffs" is insufficient to sustain a claim of fraud or

deceit. The circumstances constituting fraud must be stated with particularly. Rule 9(b), F.R.Civ.P.

Merrill Lynch filed a motion for judgment on the pleadings rather than a motion to dismiss. We have no reason to explore the technical differences between a Rule 12(b), F.R.Civ.P., motion to dismiss for failure to state a claim upon which relief can be granted and a Rule 12(c) motion for judgment on the pleadings. Our decision is based upon the legal sufficiency of the complaints. The trial court did not err in granting Merrill Lynch judgment on the pleadings.

The other *Merrill Lynch* complaint differs in that, with regard to Regulation T, reliance is not placed on the 35-day provision but on the provision requiring payment within seven days of purchase. We agree with the trial court that with regard to the customer's right to maintain an implied action against the broker for violation of Regulation T, it makes no difference whether reliance is had on the seven day or the 35-day provision.

The judgments in the appeals noted in the caption are severally affirmed.

APPENDIX B

Filed in United States District Court, District of Utah
July 8, 1975 — Verl C. Ritchie, Clerk

IN THE UNITED STATES DISTRICT COURT FOR THE DISTRICT OF UTAH — NORTHERN DIVISION

UTAH STATE UNIVERSITY OF AGRICULTURE AND APPLIED SCIENCE, a Utah body politic and corporate, *Plaintiff,* v. BEAR, STEARNS & Co., a corporation, *Defendant.*	NC 74-38
UTAH STATE UNIVERSITY OF AGRICULTURE AND APPLIED SCIENCE, a Utah body politic and corporate, *Plaintiff,* v. BLYTH EASTMAN DILLON & CO., INC., a corporation, *Defendant.*	NC 74-39
UTAH STATE UNIVERSITY OF AGRICULTURE AND APPLIED SCIENCE, a Utah body politic and corporate, *Plaintiff,* v. BOSWORTH, SULLIVAN & COMPANY, INC., a corporation, *Defendant.*	NC 74-40
UTAH STATE UNIVERSITY OF AGRICULTURE AND APPLIED SCIENCE, a Utah body politic and corporate, *Plaintiff,* v. HARRIS, UPHAM AND CO., INC., *Defendant.*	NC 74-41

UTAH STATE UNIVERSITY OF AGRICULTURE AND APPLIED SCIENCE, a Utah body politic and corporate, *Plaintiff,*

v. — NC 74-42

HORNBLOWER & WEEKS — HEMPHILL, NOYES, INC., *Defendant.*

UTAH STATE UNIVERSITY OF AGRICULTURE AND APPLIED SCIENCE, a Utah body politic and corporate, *Plaintiff,*

v. — NC 74-43

LEHMAN BROTHERS, INC., *Defendant.*

UTAH STATE UNIVERSITY OF AGRICULTURE AND APPLIED SCIENCE, a Utah body politic and corporate, *Plaintiff,*

v. — NC 74-44

SHEARSON, HAMMILL & CO., INC., *Defendant.*

UTAH STATE UNIVERSITY OF AGRICULTURE AND APPLIED SCIENCE, a Utah body politic and corporate, *Plaintiff,*

v. — NC 74-45

SUTRO & CO., *Defendant.*

THE STATE OF UTAH, and UTAH STATE UNIVERSITY OF AGRICULTURE AND APPLIED SCIENCE, a Utah body politic and corporate, *Plaintiffs,*

v — NC 74-46

MERRILL LYNCH, PIERCE, FENNER & SMITH, INC., a corporation, *Defendant.*

MEMORANDUM OPINION AND ORDER GRANTING DEFENDANT MERRILL LYNCH'S MOTION FOR JUDGMENT ON THE PLEADINGS AND ALL OTHER DEFENDANTS' MOTIONS TO DISMISS ON COUNTS I, II, III, IV and V OF THE COMPLAINTS AND DISMISSING THE PENDENT CLAIMS BASED ON STATE LAW THEORIES.

Vernon B. Romney, Utah Attorney General and David L. Wilkinson, Assistant Utah Attorney General, Salt Lake City, Utah, for plaintiff in all the above-entitled matters, and Richard W. Giauque and Brent M. Stevenson of Van Cott, Bagley, Cornwall and McCarthy, Salt Lake City, Utah, for plaintiffs in NC 74-46.

Keith E. Taylor, Daniel M. Allred and Krege B. Christensen of Parsons, Behle & Latimer, Salt Lake City, Utah, for defendants Bear, Stearns & Co., NC 74-38; Harris, Upham & Co., Inc., NC 74-41; Hornblower & Weeks — Hemphill, Noyes, Inc., NC 74-42; Lehman Brothers, Inc., NC 74-43; Shearson, Hammill & Co., Inc., NC 74-44; Sutro & Co., Inc. NC 74-45; and Merrill Lynch, Pierce, Fenner & Smith, Inc., NC 74-46.

Parker M. Nielson of Salt Lake City, Utah, for defendant Blyth Eastman Dillon & Co., Inc., NC 74-39.

Harold G. Christensen and R. Brent Stephens of Worsley, Snow & Christensen of Salt Lake City, Utah, for defendant Bosworth, Sullivan & Company, Inc., NC 74-40.

On September 20, 1974, plaintiff[1] in the above-entitled matters filed suits against the nine named stock brokerage firms. As set out below, the cases arise from similar investment transactions in the same investment program carried on by Utah State University [hereinafter the University] and in most cases the allegations in plaintiff's

[1]The University is the sole plaintiff in each of the actions with the exception of the suit filed against Merrill Lynch, NC 74-46, in which case the State of Utah is also named as a party plaintiff. A reference herein to the "University" or to the "plaintiff" is intended to embrace both plaintiffs in NC 74-46.

complaints and the defenses thereto are identical.[2] Although the cases have not been consolidated, they have been processed simultaneously and argued together, and this order will apply to all the cases as set out above.

In these actions the plaintiff University seeks to recover losses arising out of certain investments it made in common stock through the various defendant brokerage firms. For a period of time subsequent to June, 1970, the then Assistant Vice President of Finance of the University and the University's investment officer, made numerous investments in securities on behalf of the University and executed such investments through various securities brokerage houses in Utah and elsewhere, some of which are named as defendants in the actions herein. Many of the aforesaid investments were in common stocks, the market price of some of which declined markedly subsequent to the University's investment, allegedly resulting in substantial loss to the University.

On November 15, 1974, all the defendants filed a motion to dismis pursuant to Fed. R. Civ. P. 12(b), 8(e)(1), and 9(b)[3] except defendant Merrill Lynch who, on that day, filed a motion for judgment on the pleadings pursuant to Fed. R. Civ. P. 12(c). These motions were accompanied by memoranda in support thereof and the parties have filed extensive memoranda since that time; to wit, plaintiff filed a memorandum in opposition to the aforementioned motions on December 11, 1974; defendants filed a reply memorandum in support of their motions on December 17, 1974; plaintiff filed a supplemental memorandum in opposition on December 19, 1974; and on February 4 and 11, 1975, the parties filed post-hearing memoranda in support of their respective positions. Oral argument was requested by all of the parties and was heard, with counsel for all of the parties present and participating, on January 29 and 30, 1975, at which time the matter was taken under advisement. On May 5, 1975, the court filed an order allowing the parties to file affidavits or other supporting materials in support of certain factual allegations made in their motions and memoranda in order that the pending motions to dismiss could alternatively be treated by the court as motions for summary judgment pursuant to Fed. R. Civ. P. 12(b).

[2]Each case has the same variety except NC 74-43 and NC 74-45 which do not have a count based upon the alleged violation of Regulation T, promulgated by the Board of Governors of the Federal Reserve System under Section 7(a) and (c) of the Securities Exchange Act of 1934.

[3]The motion to dismiss of defendant Bosworth, Sullivan & Co., Inc., was filed pursuant to Fed. R. Civ. P. 12(b) only.

COUNTS I, II AND III OF THE COMPLAINTS.

Counts I and II of each complaint allege violations of section 15A of the Securities Exchange Act of 1934, 15 U.S.C. § 78o-3, and of the National Association of Security Dealers (hereinafter NASD) Rules of Fair Practice, Article III, § 1[4] and §2[5] promulgated by NASD thereunder. Count III is similar in nature and is based upon an alleged violation of section 6 of the 1934 Act, 15 U.S.C. § 78f and upon Rule 405 ("Know-Your-Customer Rule") of the New York Stock Exchange and Rule 411 of the American Stock Exchange (which is similar to said Rule 405), promulgated by the respective stock exchange thereunder.

In *State of Utah v. duPont Walston, Inc., et al.*, CCH

[4]This rule provides:

> "A member, in the conduct of his business, shall observe high standards of commercial honor and just and equitable principles of trade."

[5]This is the NASD "suitability rule" which states that: "In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs."

SEC. L. REP ¶ 94,812, at 96,713 (D.C. Utah, October 1, 1974) (hereinafter cited as *duPont*), this court decided that a private right of action does not exist for the aggrieved customer to sue a broker-dealer in federal court for violation of a rule of one of the self-regulatory bodies to which the broker-dealer belongs. Counts I, II and III of all of the complaints, except the *Merrill Lynch* complaint, NC 74-76, are virtually identical, both in form and in substance, to the complaint in *duPont*. Therefore, based upon the court's ruling in *duPont*, defendants'[6] motions to dismiss are hereby granted as to Counts I, II and III for failure to state a claim upon which relief can be granted.

Counts I, II and III in the *Merrill Lynch* complaint are different from their counterparts in the other complaints in that an allegation is made that the facts alleged in the first three counts also violate Rule 10b-5. It appears that plaintiffs in the *Merrill Lynch* complaint seek to buttress a Rule 10b-5 claim with reference to the NASD and Stock Exchange Rules as these rules might bear upon the duty owed to the plaintiffs by defendants. Since the court has already ruled that alleged violations of these rules do not give rise to a private right of action, it is difficult to conceive what different result or advantage plaintiffs might seek, evidentiary or otherwise, by combining the alleged violations of the rules with a 10b-5 claim. If the violation of the aforementioned rules cannot sustain a private right of action standing alone, it adds nothing to combine these allegations with alleged Rule 10b-5 violations, especially when Count IV of the complaint alleges a separate Rule 10b-5 claim. Thus, for the reasons set forth above in regard to the unavailability of a private right of action under the aforementioned rules and with the reasons set forth below regarding the Rule 10b-5 count of the

[6]All defendants are contemplated except Merrill Lynch in NC 74-46.

complaint, Counts I, II and III of the *Merrill Lynch* complaints, NC 74-46, are dismissed as being cumulative and redundant.

COUNT IV ALLEGED RULE 10b-5 VIOLATIONS

Count IV of each complaint alleges a violation of section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and Rule 10b-5 promulgated thereunder, 17 C.F.R. § 240.10b-5. Count IV, in essence, alleges that defendant omitted to state certain material facts which were necessary in order to make the statements that the defendants did make, in connection with the purchase of securities by the plaintiff, not misleading. The alleged material omissions are the same allegations which are found in the first three counts of the complaints — the suitability claims against defendant under the NASD and Stock Exchange Rules.

Omissions concerning the suitability of a stock are not the kind of omissions which give rise to Rule 10b-5 or any antifraud liability. Professor Bromberg states:

> The embryonic requirement that a broker dealer's recommendation be "suitable" for his customers, primarily in terms of risk and their needs and situations, is a product of industry self-regulation.
>
> Except for "boiler-shop"[7] cases, it presently lies outside 10b-5 and other fraud rules. 1 BROMBERG, SECURITY LAWS: FRAUD, § 5.4, at 99-100 (1974), *accord,* VI L. LOSS, SECURITIES REGULATION 3720 (Supp. 1969).

The court has not been cited a case, nor has the court found a case, which has held on the merits that a broker-dealer's omissions concerning suitability of a stock is a basis for Rule 10b-5 liability. Disregardng the suitability

[7]"Boiler room" or "boiler-shop" is a high pressure sales campaign conducted by telephone. *See VI* L. LOSS, SECURITIES REGULATION 3708 (Supp. 1969).

allegations in Count IV, which do not give rise to Rule 10b-5 liability, the complaint fails to state a claim upon which relief can be granted. Therefore, Counts IV of plaintiffs' complaints are dismissed, pursuant to Fed. R. Civ. P. 12(b)(6), for the reasons set forth herein.

REGULATIONS T AND X

Except for the complaints against Lehman Brothers, Inc. and Sutro & Co., Inc., the University alleges in Count V of the complaints a violation of Regulation T of the Federal Reserve Board by defendants. The University further alleges that it maintained a special cash account with each of the defendants, and although it did not make payment within 35 days from the trade date of certain enumerated purchase transactions, the defendants did not cancel the purchases or otherwise liquidate the University's accounts, nor did the defendants apply for an extension of time as required by Regulation T.

Regulation T, promulgated pursuant to section 7(c) of the Securities Exchange Act of 1934, 15 U.S.C. § 78g(c), determines the initial minimum margin requirements that brokers and dealers may extend to their customers. Basically, a margin requirement is the amount of down payment required on any given security purchased on credit. When, as in these cases, a special cash account is used, the purchases or sales are essentially cash, not credit transactions.[8] If the cash, in the case of a purchase, is not deposited in the account within the required time,[9] the broker-dealer must, subject to certain limitations, liquidate the account.

[8] 12 C.F.R. § 220.4 (1973).

[9] The required time in the case of a purchase through a special cash account is seven business days. 12 C.F.R. § 220.4(c)(ii)(2) (1973). However, as in this case, if payment is to be made against the delivery of the security by the broker, the required period may be extended to thirty-five days. 12 C.F.R. § 220.4(c)(ii)(5)(1973).

Thus, a Regulation T violation occurs most generally when the broker-dealer fails to make a timely liquidation.

The main purpose behind section 7 of the 1934 Act, under which Regulation T was promulgated, was set forth in the report of the House Committee on Interstate and Foreign Commerce:

> The main purpose of these margin provisions . . . is not to increase the safety of security loans for lenders. Banks and brokers normally require sufficient collateral to make themselves safe without the help of law. Nor is the main purpose even protection of the small speculator by making it impossible for him to spread himself too thinly — although such a result will be achieved as a byproduct of the main purpose.
>
> The main purpose is to give a Government credit agency an effective method of reducing the aggregate amount of the nation's credit resources which can be directed by speculation into the stock market and out of other more desirable uses of commerce and industry — to prevent a recurrence of the pre-crash situation where funds which would otherwise have been available at normal interest rates for uses of local commerce, industry and agriculture, were drained by far higher rates into security loans and the New York call market.
> H.R. Rep. No. 1383, 73d Cong., 2d Sess. 8 (1934).

As seen from the foregoing, only secondarily was the interest of lenders-brokers and investors considered.

While no civil remedy for margin violations exists under the 1934 Act, and even without the primary purpose of section 7 being the protection of the investor, courts have nevertheless been willing to imply a private right of action for investors from a mere Federal Reserve Board regulation based on one of three theories: tort, enforce-

ment, or contract.[10] Until recently the margin requirements, through Regulation T, were addressed exclusively to those who extended credit in securities transactions and, consequently, in any transaction in which credit for the purchase of securities was involved, the lender had the burden of observing margin requirements.

In 1971, Congress amended section 7 of the 1934 Act to prohibit the receipt of loans by investors in violation of the margin requirements.[11] This legislation was implemented through another Federal Reserve Board regulation, Regulation X. Regulation X makes unlawful an investor's obtaining of any credit in violation of the margin requirements; however, there is no violation if the borrower makes a good faith mistake and, upon discovery of the mistake, promptly takes whatever steps necessary to remedy the non-compliance.[12]

In passing Title III of the Bank Records and Foreign Transactions Act, under which Regulation X was promulgated, Congress was concerned with deterring tax evasion and other criminal activities.[13] Regulation X has as its stated purpose:

> [T]o prevent the infusion of unregulated credit obtained both outside and within the United States securities markets in circumvention of the provisions of the Board's margin regulations or by borrowers falsely certifying the purpose of a loan or otherwise wilfully and intentionally evading the provisions of those regulations.[14]

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[10] *See* Note, *In pari delicto as a Defense to Violations of Margin Legislation under the Securities and Exchange Act of 1934*, 9 U. SAN FRANCISCO L. REV. 113, 118-19 (1974); Note, *Regulation X: A Complexis*, 50 NOTRE DAME LAWYER 136 (1974).

[11] BANK RECORDS & FOREIGN TRANSACTIONS ACT OF 1970, TITLE III, 84 Stat. 1124, 15 U.S.C. § 78g(f)(1) (1971).

[12] 12 C.F.R. § 224.1 (1973).

[13] *See* H.R. Rep. No. 975 91st Cong., 2d Sess. 12 (1970).

[14] 12 C.F.R. § 224.1 (1973).

Both Regulations T and X were promulgated under section 7 of the 1934 Act and the purposes of both regulations are aimed at realizing or stabilizing a desirable macroeconomic goal of Congress rather than the protection of investors.

While an implied right of action under Regulation T has been granted by some courts, the promulgation of Regulation X and the facts of this case put the issue of the interface of the two regulations directly before the court. Regarding the status of the private right of action in light of the interface, at least four different results can be suggested: (1) The basis for a private damage action for violation of Regulation T has been undermined and canceled out by the amendment of section 7 of the 1934 Act and the promulgation of Regulation X thereunder for the reason that in the past under Regulation T the broker shouldered the entire responsibility for compliance with the margin requirements, but Regulation X now puts the responsibility equally upon the investor. (2) The private right of action survives in the face of the promulgation of Regulation X; however, Regulation X provides an *in pari delicto* or equal fault defense in an action by an investor that the court or jury can manipulate in making a determination as to the degree of culpability of each party. (3) The private right of action survives in the face of the promulgation of Regulation X, unless the investor has wilfully and intentionally tried to evade the provisions of the margin requirements.[15] (4) The private right of action

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[15] The first paragraph of Regulation X states its purpose as follows:

> [T]o prevent the infusion of unregulated credit obtained both outside and within the United States securities markets in circumvention of the provisions of the Board's margin regulations or by borrowers falsely certifying the purpose of a loan or otherwise *wilfully and intentionally* evading the provisions of those regulations. 12 C.F.R. § 224.1 (1973). (Emphasis added.)

The court reads this provision in two parts. The first part (ending at the first conjunction "or") explains the purpose of Regulation X in terms of

survives in the face of the promulgation of Regulation X and a broker can expose himself to almost strict liability for a violation of Regulation T for the reason that someone should be saddled with the responsibility of assuring compliance with the margin requirements and the broker is in the best posture to do this. The *in pari delicto* defense would be denied under this approach for the reason that private suits serve an important enforcement function and this enforcement purpose would disallow an *in pari delicto* defense in the securities area as it has been disallowed in the antitrust area.[16]

The court is of the opinion that, as outlined in the first alternative, the promulgation of Regulation X has removed the necessary legal underpinning for implying a private right of action for a violation of the margin requirements, and that Regulation X cancels out the private right of action implied under Regulation T. As a matter of law, therefore, Count V in the complaints which alleges a violation of Regulation T should be dismissed for failure to state a claim upon which relief can be granted. Further, however, the court is of the opinion that motions for summary judgment would have to be granted in favor of defendants for other reasons under the facts of these cases.

Most private actions under Regulation T have been brought in tort on the rationale that where a defendant's

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preventing the infusion of unregulated credit, the mere circumvention of the margin regulations. The second part (following the first conjunction "or") speaks of preventing the false certification of the purpose of a loan, and the phrase "or otherwise wilfully and intentionally evading" is thought to refer only to "falsely certifying the purpose of a loan."

To conclude that an investor need not have a wilful intent to evade the margin requirements in order to violate Regulation X is consistent both with the obvious construction of the stated purpose of the regulation as herein explained and with the tenor of Regulation T and the federal securities fraud laws which do not require wilfulness in order to show a violation.

[16]See *Perma Life Mufflers, Inc. v. International Parts Corp.*, 392 U.S. 134, 138 (1968).

violation of a prohibitory statute has caused injury to the plaintiff, the latter has a right of action if one of the purposes of the enactment is to protect interests similar to those of the plaintiffs. The implication of a private right of action under Regulation T was based upon an enactment and a regulation promulgated thereunder, neither of which had as their purpose the protection of the investor. To find a basis on which to predicate liability under Regulation T, a secondary effect of shielding the investor from spreading his resources too thinly has been recognized.[17] In light of the amendment to section 7 of the 1934 Act by Congress and the promulgation of Regulation X thereunder, it appears tenuous to continue to elevate what the report of the House Committee on Interstate and Foreign Commerce characterized as a "by-product" effect[18] into a "purpose" of the enactment and then to imply from this implied purpose a private right of action for an investor, who now, like the lender, violates the law by carrying securities with the credit obtained in a transaction involving a Regulation T violation. In 1970 when Congress considered and amended the margin provisions in section 7 of the 1934 Act, a private remedy could have been provided at that time. Instead, however, Congress dealt only with countering secret foreign financing in circumvention of the margin regulations. Commenting on the policy implicatons of Regu-

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[17]*Remars v. Clayton Securities Corp.*, 81 F. Supp. 1014, 1017 (D. Mass. 1949). *See also,* H. R. Rep. No. 1383, infra note 18, in which deterring the investor from spreading himself too thinly was seen as a "by-product" of the main purpose of the regulation.

[18]The report of the House Committee on Interstate and Foreign Commerce stated:

> The main purpose of these margin provisions . . . is not to increase the safety of security loans for lenders. Banks and brokers normally require sufficient collateral to make themselves safe without the help of law. Nor is the main purpose even protection of the small speculator by making it impossible for him to spread himself too thinly — although such a result will be achieved as a by-product of the main purpose. H.R. Rep. No. 1383, 73d Cong., 2d Sess. 8 (1934).

lation X, the court in *S.E.C. v. Packer, Wilbur & Co., Inc.*, 362 F. Supp. 510, 515 (S.D.N.Y. 1973) stated: "The clear import of Regulation X is that Congress was determined not to limit the burden of compliance to brokers alone but rather extended it to customers as well."

The court, under the circumstances, credits Congress with adequate insight to provide enforcement of its own enactments. When Congress, with the knowledge that for years a private right of action had been implied by some courts under section 7 of the 1934 Act, amends the section in a manner which directly undercuts the legal basis upon which the private right of action was grounded and fails to directly authorize a private right, it would seem pretentious for this court to expand an area of federal law so recently considered by Congress by "implying" a private damage action for those guilty of margin violations under the law. For these reasons, the court holds that a private right of action no longer exists under Regulation T due to the amendment to section 7 of the 1934 Act which resulted in the promulgation of Regulation X.[19] Therefore, Counts V of plaintiff's complaints are dismissed.

[19]The court is aware of the leading Regulation T decision of the Second Circuit, *Pearlstein v. Scudder & German*, 429 F.2d 1136 (2nd Cir. 1970), *cert. denied*, 401 U.S. 1013 (1971) which concluded that the disadvantages of giving the "unscrupulous" plaintiff a windfall recovery were outweighed by the "salutary policing effect" a private cause of action would have upon broker-dealers. *Id.* at 1141. The *Pearlstein* decision rejected the defense of *in pari delicto* in a suit alleging violation of Regulation T. However, the reasoning employed for that conclusion has been undermined by the subsequent enactment of Regulation X. The Pearlstein Court, as analogous authority, specifically referred to the antitrust decision of *Perma Life Mufflers v. International Parts*, 392 U.S. 134 (1968), which had rejected the *in pari delicto* defense in the antitrust area. In expanding on that analogy, the Second Circuit pointed out that

> [a]lthough *Perma Life* would apparently continue to deny recovery to plaintiffs who had not been coerced but who had benefited from the arrangement equally with the defendant, such a defense does not appear desirable in the securities area here involved, even when the investor may be shown to have had knowledge of margin requirements. Unlike the antitrust laws which forbid both seller and buyer to enter into a proscribed transaction, the federally imposed margin requirements forbid a broker to extend undue credit but do not forbid customers from accepting such credit. 429 F.2d at 1141.

The court further observes that even if it be argued that a private right of action should still be implied in the face of Regulation X, the authorities do not support such an implication on behalf of an institutional investor as in this case. As Judge Friendly observed in a persuasive dissent in *Pearlstein v. Scudder & German*, 429 F.2d 1136, 1148 (2nd Cir. 1970), *cert. denied*, 401 U.S. 1013 (1971):

> To be sure, it may be proper in some instances to impose civil liability in furtherance of the subsidiary purpose of § 7(c), protection of the innocent "lamb" attracted to speculation by the possibility of large profits with low capital investment. . . . Pearlstein, an experienced speculator, was no lamb, and the trial judge specifically found that he was not induced to enter into the transactions by any expectation that defendant would be slow in selling him out if he were to default in payment.

The University, an institutional investor (and an agency of the sovereign) which must operate under guide-

The premise of that position — that buyers are not prohibited from entering into improper margin transactions — has been overruled by Regulation X. Thus, the primary ground of the *Pearlstein* argument for rejecting the *in pari delicto* defense in Regulation T cases is no longer valid. In addition, the analogy to the private policing policy of antitrust laws is weak at best, since those statutes specifically provide for private civil actions and encourage private enforcement actions by the treble damages provisions. In contrast, no such Congressional imprimatur exists for private actions under Regulation T. Thus, antitrust cases such as *Perma Life* are inappropriate authority in this case for rejecting the *in pari delicto* defense, or even for the importance of a private right of action.

In *Pearlstein* Judge Friendly dissented on the ground that the holding would encourage customers to violate the margin rules. 429 F.2d 1148. A similar argument could be made against the court's holding in the instant case; that is, by abolishing a private right of action altogether, the incentive to comply with margin requirements is reduced for both broker-dealers and customers and, as a consequence, "devil's bargains" might result, depending upon the probabilities of detection through public enforcement. The court believes, however, that the potential for this kind of abuse is diminished by the current disinclination of broker-dealers to jeopardize their public image, their relationship with the SEC, and their standing among other broker-dealers in the industry. There are a sufficient number of other enforcement avenues of the regulations in question.

lines established by statutes, regulations and rules, engaged itself in a far-flung, wide-ranging investment program in common stocks which it now asserts it had no authority to do. Neither the main purpose of section 7(c) — e.g., ". . . to prevent a recurrence of the pre-crash situation where funds which would otherwise have been available at normal interest rates for use of local commerce, industry and agriculture. . . ."[20] — nor the secondary purpose — e.g., the ". . . protection of the small speculator by making it impossible for him to spread himself too thinly. . . ."[21] — are served by implying a private right of action under the facts of this case. The funds that were invested by the University would not, directly at least, be available to support local commerce, industry and agriculture, nor can the University be said to be the "small speculator" concerning whom Congres might have had secondary concern in making it impossible to spread itself too thinly. A threshold requirement of serving or forwarding the public purposes of section 7(c) of the 1934 Act must be met before a private right of action for civil liability can be implied thereunder. The rationale that argues for implying a private right of action for a financially strong institutional investor under either the primary or secondary purpose of section 7(c) hangs from a thin, fragmented thread. The court is unaware of any authority under which private civil liability should be implied or sustained in this case.

Lastly, even if a private right of action should still be implied in the face of Regulation X and the other considerations set out above, at the very least, Regulation X would provide an *in pari delicto* or equal fault defense which would sustain a motion for summary judgment in favor of defendants under the facts of this case. Regulation X makes the University equally responsible and liable with

[20]H.R. Rep. No. 1383, 73d Cong., 2d Sess. 8 (1934).
[21]*Id.*

the defendants for the alleged margin violations. Ignorance of the law is generally no defense when charged with its violation; however, in this regard, the University cannot be characterized as unknowledgeable with regard to the requisites of Regulation X when it had ready access to legal counsel and also had available to it the experience and manpower of the office of the Utah Attorney General, itself a law enforcement agency, charged with advising various state agencies concerning the exercise of their powers. It is interesting to observe that the court has not been advised that the University took advantage of that portion of Regulation X which allows a purchaser to correct a non-compliance by promptly taking whatever remedial steps are necessary upon discovery of the violation.[22] At best, therefore, the plaintiff's theory is novel, in that it seeks to selectively rescind and be made whole on all its loss transactions while keeping the benefits of its gain transactions. The court is unaware of any authority which would allow such a favorable remedy to a plaintiff who is equally guilty of violation of the regulation under which liability would be imposed against the defendant. Neither justice nor reason provide grounds on which to sustain a cause of action for the University's theory under all the circumstances of this case.

PENDENT CLAIMS BASED ON STATE LAW

In *State of Utah v. duPont Walston, Inc., et al.,* CCH SEC. L. REP. ¶ 94,812, at 96,713 (D.C. Utah, October 1, 1974), the court was concerned with the pendent state law claims, and the court's observations therein expressed are equally applicable again in these cases. In *United Mine Workers of America v. Gibbs,* 383 U.S. 715 (1966) the Supreme Court held that as a matter of constitutional power, pendent federal jurisdiction exists whenever state

[22]12 C.F.R. § 224.6(a)(1973).

and federal claims "derive from a common nucleus of operative fact" and are such that a plaintiff "would ordinarily be expected to try them all in one judicial proceeding." *Id.* at 725. The Court, however, stated further in this regard:

> That power need not be exercised in every case in which it is found to exist. It has consistently been recognized that pendent jurisdiction is a doctrine of discretion, not of plaintiff's right. Its justification lies in considerations of judicial economy, convenience and fairness to litigants; if these are not present a federal court should hestitate to exercise jurisdiction over state claims, even though bound to apply state law to them, *Erie R. Co. v. Tompkins,* 304 U.S. 64. Needless decisions of state law should be avoided both as a matter of comity and to promote justice between the parties, by procuring for them a surer-footed reading of applicable law. *Certainly, if the federal claims are dismissed before trial, even though not insubstantial in a jurisdictional sense, the state claims should be dismissed as well.* Similarly, if it appears that the state issues substantially predominate, whether in terms of proof, of the scope of the issues raised, or of the comprehensiveness of the remedy sought, the state claims may be dismissed without prejudice and left for resolution to state tribunals. *Id.* at 726-27. (Emphasis added.)

These cases present a clear instance where state claims should be dismissed now that the determination has been made that there is no federal claim. The federal claims have been dismissed before trial. The remaining pendent claims involve complicated questions necessitating the construction of a morass of seemingly conflicting state statutes in order to determine the scope of power and authority of a state institution to invest in common stocks. This is a classic instance when "needless decisions of state law should be avoided . . . as a matter of comity . . . by procuring . . . a surer-footed reading of applicable law." Id. at 726.

It is appropriate to observe that the court is advised that by virtue of a state court suit brought by the University many of the issues involved in the pendent claims are on appeal to the Utah Supreme Court. It should be the primary right of the State Supreme Court to construe the state statutes involved in these pendent claims. It would be abortive for this court to decide questions so fundamentally fraught with state interests when the issues are on appeal before the Utah court. Therefore, based upon the foregoing reasons,

IT IS HEREBY ORDERED that defendant Merrill Lynch's motion for judgment on the pleadings[23] and all other defendants' motions to dismiss[24] on Counts I, II, III, IV and V of the complaints are granted for failing to state a claim upon which relief can be granted, and plaintiff's complaints are dismissed, along with the causes of action

[23]The court is aware that a motion for judgment on the pleadings is theoretically directed towards a determination of the substantive merits of a controversy, but that it also has an incidental function under Fed. R. Civ. P. 12(h)(2) of permitting certain procedural defects, as in this case — a defense of failure to state a claim upon which relief can be granted — to be raised after the close of the pleadings. 5 WRIGHT & MILLER, FEDERAL PRACTICE AND PROCEDURE: Civil § 1369, at 701 (1969). The court, therefore, considers defendant Merrill Lynch's motion for judgment on the pleadings to be essentially in the same procedural posture as the other defendants' motions to dismiss filed pursuant to Fed. R. Civ. P. 12(b)(6).

[24]Although affidavits and other supporting materials have been filed by the respective parties, the court elects to ground its holding herein on the defendants' original motions to dismiss.

based thereon, and the remaining state law pendent claims are dismissed without prejudice.[25]

DATED this 8th day of July, 1975.

ALDON J. ANDERSON
United States District Judge

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[25]The court has noted the suggestion of plaintiff's counsel in its brief that for the reason that this court has previously upheld identical 10b-5 counts in the *duPont* complaint (NC 74-9) and in the *Merrill Lynch* complaint (NC 74-46), that amendment to the complaint might be allowed if the court had question as to the sufficiency of the 10b-5 counts. Plaintiff's arguments in this regard are not well taken and they inaccurately represent this court's prior rulings. In *duPont,* the defendant filed a motion to dismiss all counts in the complaint and the motion was granted only in respect to Counts I, II and III, which were the "suitability" counts as in the instant cases. However, when the defendant in *duPont* filed its motion to dismiss as to all counts, the complaint did not at that time contain a 10b-5 count. Plaintiff amended the complaint to include the 10b-5 count after the motion to dismiss was filed. The sufficiency of the 10b-5 count in *duPont* was never briefed, argued, or considered by the court. Further, the court has never ruled on the viability of the 10b-5 count in the *Merrill Lynch* complaint. Counts I, II and III in the *Merrill Lynch* complaint are, as the court has previously stated in this order, different from their counterparts in the other complaints in that they are bottomed on alleged violations of Rule 10b-5 as well as on alleged violations of the stock exchange rules in question. In this court's order of October 11, 1974, in the *Merrill Lynch* case, a motion to dismiss these three counts, on the grounds that a private right of action does not exist, was denied. In that order the court merely held that it read the complaint to allege a 10b-5 claim, rather than a claim based solely on the stock exchange rules. Today the court has considered the sufficiency of those three counts and has determined that they should be dismised, among other reasons, as being cumulative and redundant since Count IV of the *Merrill Lynch* complaint also alleges a 10b-5 violation. *Supra* at 7.

In view of the fact that plaintiff has chosen to stand on the 10b-5 pleading in its present form by not seeking opportunity to amend prior to the disposition of the motions to dismiss, and after now considering the nine complaints herein and the extensive briefing and argument in pretrial motions in which the court has not been advised nor become aware of even an oblique reference to any additional facts that might be pleaded in order to state a claim in this regard, amendment at this juncture appears futile. See *Forman v. Davis*, 371 U.S. 178, 182 (1962). For these reasons, the court does not construe plaintiff's suggestion that amendment might be allowed as a motion for leave to amend.

APPENDIX C

Filed in United States District Court, District of Utah
February 3, 1976 — Verl C. Ritchie, Clerk

IN THE UNITED STATES DISTRICT COURT FOR THE DISTRICT OF UTAH—NORTHERN DIVISION

UTAH STATE UNIVERSITY OF AGRICULTURE AND APPLIED SCIENCE, a Utah body politic and corporate,

Plaintiff,

vs.

MERRILL LYNCH, PIERCE, FENNER & SMITH, INC., a corporation,

Defendant,

NC 75-58

ORDER GRANTING MOTION TO DISMISS

On December 8, 1975, the defendant in the above-entitled matter filed a motion requesting that the case be dismissed. The defendant also filed memorandum and other supporting materials. On December 30, 1975, the plaintiff filed a memorandum opposing the defendant's motion and the defendant filed a reply memorandum on January 9, 1976. The court has carefully considered the filed materials and considers itself to be well advised concerning the motion.

The basis of the defendant's motion is the contention that, as a matter of law, a violation by a broker-dealer of Regulation T promulgated by the Board of Governors of the Federal Reserve System (12 C.F.R. § 220) does not give rise to a private right of action. The defendant bases this contention on an order entered on July 8, 1975, by this court in a series of cases brought by the plaintiff, Utah State University, against several brokerage houses, includ-

ing the defendant in this case. See *Utah State University v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, NC 74-46. The plaintiff's response argues that this case should not be dismissed on the same grounds as the prior suit because a new legal theory is being advanced which requires that factual issues, relating to the defendant's good faith, be resolved. In its reply memorandum, the defendant argues that the addition of two new issues does not change the fact that, since the promulgation of Regulation X (12 C.F.R. § 224), Regulation T does not give rise to a private right of action.

For the reasons explained on pages 8 to 16 of the July 8, 1975, order in *Utah State University v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, NC 74-46, the defendant's motion should be granted.

IT IS HEREBY ORDERED that the defendant's motion to dismiss is granted.

DATED this 2nd day of February, 1976.

ALDON J. ANDERSON
United States District Judge

APPENDIX D

Regulation T of the Federal Reserve Board, 12 C.F.R. § 220 (1977):

.4(a)(1) Pursuant to this section, a creditor may establish for any customer one or more special accounts.

* * * *

.4(c)(1) In a special cash account, a creditor may affect for or with any customer bona fide cash transactions in securities in which the creditor may:

(i) Purchase any security for . . . any customer, provided funds sufficient for the purpose are already held in the account or the purchase or sale is in reliance upon an agreement accepted by the creditor in good faith that the customer will promptly make full cash payment for the security and the customer does not contemplate selling the security prior to making such payment.

* * * *

.4(c)(2) In case a customer purchases a security (other than an exempted security) in the special cash account and does not make full cash payment for the security within 7 days after the date on which the security is so purchased, the creditor shall, except as provided in subparagraphs (3)-(7) of this paragraph, promptly cancel or otherwise liquidate the transaction or unsettled portion thereof.

* * * *

.4(c)(5) If the creditor, acting in good faith in accordance with subparagraph (1) of this paragraph, purchases a security for a customer, with the understanding that he is to deliver the security promptly to the customer, and the full cash payment to be made by the customer is to be made against such delivery, the creditor may at his option treat the transaction as one to which the period applicable under subparagraph (2) of this para-

graph is not the 7 days therein specified but 35 days after the date of such purchase or sale.

* * * *

.4(c)(6) If an appropriate committee of a national securities exchange or a national securities association is satisfied that the creditor is acting in good faith in making the application, that the application relates to a bona fide cash transaction, and that exceptional circumstances warrant such action, such committee, on application of the creditor, (i) may extend any period specified in subparagraph (2) . . . or (5) of this paragraph for one or more limited periods commensurate with the circumstances.

* * * *

.4(c)(7) The 7-day periods specified in this paragraph refer to 7 full business days. The 35-day period and the 90-day period specified in this paragraph refer to calendar days, but if the last day of any such period is a Saturday, Sunday, or holiday, such period shall be considered to end on the next full business day.

Regulation X of the Federal Reserve Board, 12 C.F.R. § 224 (1977):

.2(a) A borrower shall not obtain any purpose credit from within the United States unless he does so in compliance with the following conditions:

* * * *

.2(a)(2) Credit obtained from a broker/dealer shall conform to the provisions of Part 220 of this chapter (Regulation T), which is hereby incorporated in this part (Regulation X). When the term "broker/dealer" is used in this part (Regulation X), it means a person who is a broker or dealer, including every member of a national securities exchange, and includes a foreign branch or subsidiary of a broker/dealer.

* * * *

.2(b)(1) A U.S. person or foreign person controlled by a U.S. person or acting on behalf of or in conjunction with such a person shall not obtain any purpose credit from outside the United States except in compliance with the following conditions:

* * * *

.2(b)(1)(ii) Credit obtained from a foreign branch or subsidiary of a broker/dealer shall conform to the provisions of Part 220 of this chapter (Regulation T).

.6(a) An innocent mistake made in good faith by a borrower in connection with the obtaining of a credit shall not be deemed to be a violation of this part (Regulation X) if promptly after discovery of the mistake the borrower takes whatever action is practicable to remedy the noncompliance.

APPENDIX E

Securities and Exchange Act of 1934, § 7, 15 U.S.C. § 78 g (1970):

> (a) For the purpose of preventing the excessive use of credit for the purchase or carrying of securities, the Board of Governors of the Federal Reserve System shall, prior to October 1, 1934, and from time to time thereafter, prescribe rules and regulations with respect to the amount of credit that may be initially extended. . . .
>
> * * * *
>
> (c) It shall be unlawful for any member of a national securities exchange or any broker or dealer, directly or indirectly, to extend or maintain credit or arrange for the extension or maintenance of credit to or for any customer —
>
>> (1) on any security (other than an exempted security), in contravention of the rules and regulations which the Board of Governors of the Federal Reserve System shall prescribe under subsections (a) and (b) of this section;
>
> * * * *
>
> (f)(1) It is unlawful for any United States person, or any foreign person controlled by a United States person or acting on behalf of or in conjunction with such person, to obtain, receive, or enjoy the beneficial use of a loan or other extension of credit from any lender . . . for the purpose of (A) purchasing or carrying United States securities, . . . if, under this section or rules and regulations prescribed thereunder, the loan or other credit transaction is prohibited. . . .

IN THE

Supreme Court of the United States

October Term, 1977

No. 77-99

UTAH STATE UNIVERSITY OF AGRICULTURE
AND APPLIED SCIENCE, *Petitioner,*

vs.

BEAR, STEARNS & CO.
et al., *Respondents*

BRIEF OF RESPONDENTS BEAR STEARNS & CO., HORNBLOWER & WEEKS-HEMPHILL, NOYES, INC., SHEARSON, HAMMILL & CO., SUTRO & CO., INC. AND MERRILL LYNCH, PIERCE, FENNER & SMITH, INC. IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

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These Respondents disagree with the question presented and statement of the case as set forth in the Petition for Certiorari. Accordingly, they present the question at issue and the statement of the case as follows:

QUESTION PRESENTED

Whether, in the absence of allegations of scienter, extensions of credit by a securities broker-dealer in violation of Regulation T of the Federal Reserve System (governing the extension of credit by broker-dealers for the purpose of purchasing or carrying securities) give rise to a private cause of action by a customer where the extensions

of credit occurred after the promulgation of Federal Reserve System Regulation X (governing the obtaining of securities credit by borrowers).

STATEMENT OF THE CASE

The Petition involves eight companion cases filed by Petitioner Utah State University of Agriculture and Applied Science (hereinafter "the University") against seven corporations or partnerships engaged as broker-dealers in the securities industries (hereinafter referred to as "broker-dealers"). Case No. 75-1861 in which Sutro & Co. is named defendant contains no allegations of violations by it of the federal securities laws here at issue and for this reason should not have been included in the University's petition. The following representations and arguments relate only to those actions other than the Sutro action.

The complaints were filed in September, 1974, with the exception of the complaint in Case No. 75-1330 which was filed in November, 1975, in the United States District Court for the District of Utah and allege that the broker-dealers, among other things, failed to comply with section 7(c) of the Securities Exchange Act of 1934 and Regulation T promulgated thereunder by the Board of Governors of the Federal Reserve System by failing to liquidate the University's orders for securities purchases when the University failed to make payment for the same within the time set by Regulation T. Neither section 7(c) nor Regulation T explicitly provide for a private right of action by a customer against his broker-dealer. The transactions at issue occurred after congressional enactment of section 7(f) of the '34 Act and the promulgation thereunder of Regulation X by the Federal Reserve System. The complaints contain no allegation that the broker-dealers' alleged violation of Regulation T was in any way fraudulent or deceitful.

The district court granted the broker-dealers' motions to dismiss in each action with the exception of Case No. 75-1862, in which the court granted the broker-dealer's motion for judgment on the pleadings. The district court so ruled upon the facts alleged after concluding that any implied right of action arising under section 7(c) of the '34 Act and Regulation T was eliminated by enactment of section 7(f) of the '34 Act and the promulgation of Regulation X thereunder. In the alternative, the court granted the broker-dealers summary judgment because even if an implied right of action remains under Regulation T, the University was *in pari delicto* with the broker-dealers as to any violation of Regulation T under the uncontroverted facts. (The court requested discovery of facts relating to the University's knowledge and sophistication in securities transactions in order to treat the motion to dismiss as a Rule 56 motion for summary judgment pursuant to Rule 12(b)(6) of the Federal Rules of Civil Procedure.)

In a unanimous decision, the United States Court of Appeals for the Tenth Circuit affirmed, holding that no private right of action exists for violation of Regulation T under the facts alleged. The Tenth Circuit implied, however, that a private action may remain where fraudulent or deceitful conduct is alleged (Page A-12 of Appendix). The University petitioned the Tenth Circuit for a rehearing and suggested that it be heard en banc. Its petition was denied on March 18, 1977.

ARGUMENT

Contrary to the University's arguments, there is no reason for this Court to review the Tenth Circuit's holding with respect to Regulation T. Rather, there is good

reason not to review that decision: the Tenth Circuit opinion does not conflict with any other circuit court decision and does not present an important question of federal law which has not been, or should be, settled by this Court.

A. THE OPINION OF THE COURT OF APPEALS FOR THE TENTH CIRCUIT IS NOT IN CONFLICT WITH ANY OTHER CIRCUIT COURT DECISION.

The University erroneously asserts that the decision rendered by the Tenth Circuit is contrary to a substantial body of case law which has arisen with regard to the existence of an implied cause of action under section 7(c) and Regulation T. In fact, there is no conflict between the circuits on this issue. On the contrary, the one circuit, the Second, to address the issue raised by the University, first suggested the position taken by the Tenth Circuit. *Pearlstein v. Scudder & German,* 527 F.2d 1141 (2nd Cir. 1975) (*"Pearlstein II"*). And the only district court case Petitioner cites as taking a contrary position is not in direct conflict with the Tenth Circuit Court opinion. *McNeal v. Paine, Webber, Jackson & Curtis, Inc.,* 429 F. Supp. 359 (N.D. Ga. 1977). These and other cases will be dismissed more fully, *infra.*

Regulation T, 12 C.F.R. 220.1 et seq., was promulgated pursuant to section 7(c) of the Securities Exchange Act of 1934 and provides for purposes material here that a broker-dealer must liquidate a customer's order for the purchase of a security if the customer fails to make payment within a certain time. Neither section 7(c) nor Regulation T places any burden or obligation for compliance upon the customer. Because the burden of compliance rests solely on the broker-dealer, the Second Circuit in a divided decision in *Pearlstein v. Scudder & German,* 429 F.2d 1136 (2nd Cir. 1970), *cert. denied,* 401 U.S. 1013 (1971) (*"Pearlstein I"*),

found an implied cause of action in favor of the customer and against the broker-dealer. Other circuits, in decisions cited by the University in its Petition, took the same view. Then in 1970, Congress amended section 7 by adding subsection (f) and the Board of Governors of the Federal Reserve System promulgated thereunder Regulation X, 12 C.F.R. 224.1-224.6, which placed the burden of compliance with Regulation T (and other regulations relating to the extension of credit for the purpose of purchasing or carrying securities) upon the customer as well as the broker-dealer. Regulation X at 12 C.F.R. 224.2(a) states:

> A borrower shall not obtain any purpose credit from within the United States unless he does so in compliance with the following conditions:
>
> * * *
>
> (2) credit obtained from a broker/dealer shall conform to the provisions of Part 220 of this chapter (Regulation T), which is hereby incorporated in this part (Regulation X).

Because the burden for compliance with Regulation T was shifted from the broker-dealer to both the broker-dealer and the customer, the Second Circuit in *Pearlstein II, supra,* concluded at 527 F.2d at 1145 n.3, that:

> The effect of these developments is to cast doubt on the continuing validity of the rationale of our prior holding.

Apart from the Second and Tenth Circuits, no other court of appeals has addressed the issue. All other circuit opinions on Regulation T pertain to facts predating section 7(f) and Regulation X and for this reason do not treat the issue raised by Petitioner here and could not conflict with the decision of the Tenth Circuit. The University attempts to bring these early circuit decisions into conflict by making the unfounded suggestion that the Tenth

Circuit opinion, like the early decisions of the other circuits, somehow did not take into account or rest upon section 7(f) and Regulation X. That portion of the Tenth Circuit opinion reproduced at pages A-11 through A-13 of the Appendix makes clear that the opinion squarely rests upon this recent congressional and regulatory action.

The only case Petitioner seriously contends to be in conflict with the Tenth Circuit holding is a district court opinion and not a circuit decision. *McNeal v. Paine, Webber, Jackson & Curtis, Inc.*, 429 F. Supp. 359 (N.D. Ga. 1977). Even so, it is clear that this decision is not inconsistent with the Tenth Circuit. In *McNeal*, the district court agreed with the Tenth Circuit that the enactment of section 7(f) and the promulgation of Regulation X places in doubt the right of a customer to recover for margin violations of its broker. 429 F. Supp. at 365. It held, however, that a private right of action under Regulation T might still exist where an investor has been affirmatively misled by his broker into believing that his account is in compliance with Regulation T, and as a result, suffers tangible losses when his broker sells certain stocks at an unfavorable price in order to comply belatedly with that regulation. Significantly, there is no similar allegation here that the broker-dealers affirmatively misled the University into believing that it was in compliance with Regulation T or X and there is no allegation that the broker-dealers caused the University a loss by liquidating any of the University's orders for purchases in order for the broker-dealers to comply belatedly with Regulation T.

In its Petition, the University suggests that the Tenth Circuit's holding is so narrow that no private right of action may be implied under any circumstances. This is not correct. The Tenth Circuit implied that an action may still be maintained where fraud or deceptive conduct is

alleged. It did so by rejecting as "not pertinent" a ruling by the Northern District of Illinois, *Neill v. David A. Noyes & Co.*, 416 F. Supp. 78 (N.D. Ill. 1976), that an implied action still exists under Regulation T, because in that case, unlike in this action, fraud or deceptive conduct was alleged. This would conform to this Court's holding in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, *reh. denied*, 425 U.S. 986 (1976), with respect to another section of the '34 Act not explicitly providing for private suits, section 10(b). There the Court implied a private cause of action only where scienter — intent to deceive, manipulate, or defraud — is alleged.

Because no other circuit court is in conflict with the Tenth Circuit's holding, the University's Petition for Certiorari should be denied.

B. THE QUESTION PRESENTED IS NOT AN IMPORTANT QUESTION OF FEDERAL LAW WHICH HAS NOT BEEN, BUT SHOULD BE, SETTLED BY THIS COURT.

Contrary to the University's argument, the participation by the Federal Reserve Board as amicus curiae in the University's petition for rehearing before the Tenth Circuit does not elevate the question presented to an important question of federal law. The Federal Reserve Board continues to have the right to seek compliance with section 7 and the regulations promulgated thereunder. Petitioner suggests that because the Federal Reserve Board opposed the Tenth Circuit ruling that this alone is evidence of error and for this reason the Petition raises an important question of federal law. This Court has often given little credence to an agency's view in determining whether private rights of action arise out of statutes or regulations. In *Piper v. Chris-Craft Industries, Inc.*,

51 L. Ed. 2d 124, 97 S.Ct. 926 (1977), the Court stated with respect to the position taken by the Securities & Exchange Commission that the Williams Act, section 14(e) of the '34 Act, implies a private right of action for an unsuccessful tender offeror, 51 L. Ed 2d at 153 n.27:

> Even if the agency spoke with a consistent voice, however, its presumed "expertise" in the securities-law field is of limited value when the narrow legal issue is one peculiarly reserved for judicial resolution, namely whether a cause of action should be implied by judicial interpretation in favor of a particular class of litigants. Indeed, in our prior cases relating to implied causes of action, the Court has understandably not invoked the "administrative deference" rule, even when the SEC supported the result reached in the particular case. J. I. Case v. Borak, supra; Superintendent of Insurance v. Bankers Life & Cas. Co. That rule is more appropriately applicable in instances where, unlike here, an agency has rendered binding, consistent, official interpretations of its statute over a long period of time [citations omitted].

The Federal Reserve Board has not rendered "binding, consistent, official interpretations" of section 7(c) or Regulation T that an implied private right of action exists in favor of a broker-dealer's customer.

Petitioner also contends that the question presented is an important federal question because, it asserts, Congress relies upon actions by private litigants for enforcement of Regulation T. This argument simply begs the question of congressional intent and of itself does not create an important question of federal law. At the very least, the University should offer some evidence of any such legislative intent. It has not, because there is little or none. Indeed, the fact that Congress amended section 7 to undermine the basis upon which numerous courts had

repeatedly found implied private remedies evidences a contrary legislative intent.

Lastly, it is evident that the question presented is not an important question of federal law because, despite the volume of credit extended in this country for the purpose of purchasing or carrying securities, only one circuit, the Tenth, has been asked to confront this issue directly since the passage of section 7(f) in 1970.

CONCLUSION

For the reasons set forth above, Respondent broker-dealers respectfully submit that Petitioner has failed to raise any issue meriting review by this Court. There are no conflicts among the circuits and the question presented is not an important question of federal law. Only one circuit, the Tenth, has squarely ruled on the issue raised and the only other circuit, the Second, even to approach the issue has indicated that it would likely take the same position. The Petition for Writ of Certiorari should be denied.

Respectfully submitted this 14th day of September, 1977.

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IN THE

Supreme Court of the United States

No. 77-99

UTAH STATE UNIVERSITY OF AGRICULTURE AND APPLIED SCIENCE,
Petitioner,

vs.

BEAR, STEARNS & CO., ET AL.,
Respondents.

RESPONDENTS BOSWORTH, SULLIVAN & CO., INC'S BRIEF IN OPPOSITION

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RESPONDENTS BOSWORTH, SULLIVAN & CO., INC'S BRIEF IN OPPOSITION

QUESTION PRESENTED

Whether, under the circumstances and facts as alleged in the present case, Petitioner has a private right of action against Respondent for alleged violations of Regulation T promulgated by the Federal Reserve Board under Section 7 of the Securities Exchange Act of 1934.

STATEMENT OF THE CASE

The Petition involves eight companion cases filed by the Petitioner, Utah State University of Agriculture and Applied Science (hereinafter "The University") against seven corporations or partnerships engaged as broker-dealers in the securities industries (hereinafter referred to as "broker-dealers").

The initiating Complaint was filed on September 20, 1974, alleging that the broker-dealers, among other things, had failed to comply with Section 7 of the 1934 Securities Exchange Act and Regulation T promulgated thereunder by the Board of Governors of the Federal Reserve System.

Identical Motions to Dismiss were filed by eight of the broker-dealers in November of 1974, moving the United States District Court for the District of Utah (hereinafter referred to as the "District Court") to dismiss the Complaints filed against the defendants on all counts, including the counts dealing with margin requirements contained in Section 7 of the Securities Exchange Act and Regulation T promulgated thereunder. One of the broker-dealers, Merrill Lynch, filed a Motion for Judgment on the Pleadings raising issues identical to the Motions to Dismiss.

On July 8, 1975, the District Court dismissed all counts including those involving Regulation T and Section 7 of the Securities Exchange Act.

The District Court reasoned on several theories that the Regulation T counts of the University's Complaints failed to state a claim upon which relief can be granted. First, the Court held that there was no private right of action under Regulation T because of the promulgation of Regulation X, 12 C.F.R. §224.1 (1973), which made unlawful the obtaining by an investor of credit in violation of the margin requirements. Second, the Court held that an implied right of action based upon Regulation T is not available in any event to an institutional investor such as the University. Third, the District Court held that even if a private right of action against the broker-dealers for violations of Regulation T were available to the University, the defense of *in pari delicto* would sustain a Motion for Summary Judgment in favor of the broker-dealers since

the University was equally responsible and liable with them for any alleged margin violations and had available legal counsel from the Utah Attorney General's Office to guide it in its investment program.

The United States Court of Appeals for the Tenth Circuit (hereinafter referred to as the "Circuit Court") affirmed in an unanimous decision, holding that the University had no private right of action against the broker-dealers for violations of Regulation T under the facts pleaded. The Circuit Court did imply, however, that a private action may exist where fraudulent, deceitful or other intentional conduct on the part of broker-dealers is alleged (See Appendix at A-12).

The University petitioned for a rehearing with a suggestion for a rehearing *en banc* which was denied on March 18, 1977.

ARGUMENT

The reasons advanced by the University for granting a Writ of Certiorari in the present case are non-existent because the Circuit Court's opinion relative to Regulation T does not conflict with any other circuit court decision and does not present an important question of federal law which has not been, or should be, settled by this Court.

Furthermore, a review of the Circuit Court's opinion, as well as that of the District Court, reveals a holding harmonious with the legislative intent behind the statutes and regulations involved. Moreover, under the circumstances of the present case, there exists no theory upon which a private right of action in favor of the University could be justified.

A. THE OPINION OF THE CIRCUIT COURT IS NOT IN CONFLICT WITH ANY OTHER CIRCUIT COURT DECISION.

The University asserts the decision rendered by the Circuit Court is contrary to a substantial body of case law which has arisen with regard to the existence of an implied private cause of action under Section 7(c) and Regulation T. In fact, there is no conflict between the circuits on this issue.

The Board of Governors of the Federal Reserve System was authorized by Section 7 of the Securities Exchange Act of 1934 to "prescribe rules and regulations with respect to the amount of credit that may be initially extended and subsequently maintained on any security." 15 U.S.C. §78g(a) (1971). Accordingly, the Board promulgated margin rules regulating extension of credit by broker-dealers (Regulation T), banks (Regulation U), and other lenders (Regulation G).

Regulation T sets forth the initial minimum margin requirements that brokers and dealers may extend to their customers and, in the case of cash purchases, requires a broker-dealer to make certain that there is sufficient cash in the investor's account within specified time limits.[1] If, after the purchase, payment is not made within the required time, the broker-dealer *must* "cancel or otherwise liquidate the transaction." 12 C.F.R. §220.4(c)(ii)(2) (1973).

Section 7 of the Securities Exchange Act of 1934 was amended by Title III of the Bank Records and Foreign

[1]The required time in the case of a cash account is normally seven business days. 12 C.F.R. §220.4(c)(ii)(2) (1973). However, if a creditor purchases a security for a customer or sells a security to a customer with the understanding that payment is to be forthcoming upon delivery to the customer, the required time may be extended to 35 days. 12 C.F.R. §220.4(c)(ii)(5) (1973).

Transactions Act of 1970 for the purpose of prohibiting the receipt of credit by investors in violation of margin requirements. 15 U.S.C. §78g(f)(1)(1970). In accordance with and pursuant to the amendment the Federal Reserve Board promulgated Regulation X making unlawful the obtaining of credit by an investor in violation of the margin requirements. 12 C.F.R. §224.1 (1973).[2]

The University alleges that the broker-dealers violated Regulation T by not liquidating certain stock-purchase transactions in which payment was not made in the required time under Regulation T and its claims are based on the assumption that the University, as an investor, has an implied cause of action under Regulation T against the broker-dealers. Such a cause of action must be "implied" because Section 7(c) of the Securities Exchange Act of 1934 does not expressly provide a private cause of action for violation of Regulation T or the other margin regulations.

In urging the courts below to recognize such a private cause of action, the University has consistently pointed to various circuit court cases in which courts have held that Section 7 and the margin regulations promulgated pursuant to it may, in appropriate cases, provide a basis for a private cause of action.

The leading case recognizing such an implied cause of action is *Pearlstein v. Scudder & German*, 429 F.2d 1136 (2d Cir. 1970), *cert. denied* 401 U.S. 1013 (1971). In *Pearlstein* the court reasoned that a private cause of action based on Regulation T would have a "salutary policing effect" upon broker-dealers and that knowing participation

[2]Regulation X expressly incorporates the provisions of Regulation T:

> Credit obtained from a broker/dealer shall conform to the provision of Part 220 (Regulation T) of this chapter, which is hereby incorporated in this part (Regulation X). 12 C.F.R. §224.2(a)(2).

of the investor in the activity violative of Regulation T would not bar recovery because the statute only prohibited broker-dealers from extending credit beyond margin requirements and did not forbid customers from accepting the credit. *Id.* at 1141.[3]

However, all of these cases, many of which are relied upon by the University in its Petition, discuss whether an implied cause of action existed under Regulation T prior to the enactment of Section 7(f) in 1970 and the promulgation of Regulation X in 1971.

On the other hand, in this case, the Circuit Court was presented with the question of whether the University, in light of Regulation X, and under the specific facts presented, was entitled to bring a private action against the broker-dealers under Regulation T. Accordingly, the Circuit Court, as well as the District Court, reviewed and analyzed the pre-Regulation X decisions, considered the legislative history behind Regulations T and X[4] and con-

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[3]Judge Friendly dissented in *Pearlstein* and argued:

> Even assuming that the purposes of §7(c) would be served by a degree of private enforcement, I question whether the majority's free-wheeling approach will have the desired effect. As a result of it, speculators will be in position to place all the risk of market fluctuations on their brokers, if only the customer's persuasion or the broker's negligence causes the latter to fail in carrying out Regulation T to the letter. *Any deterrent effect of threatened liability on the broker may well be more than offset by the inducement to violations inherent in the prospect of a free ride for the customer who, under the majority's view, is placed in the enviable position of "heads-I-win tails-you-lose."* 429 F.2d at 1148. (emphasis added).

[4]In reaching the conclusion that subsequent to the promulgation of Regulation X, the University has no private cause of action against the broker-dealers, the lower courts both specifically referred to the legislative history behind Regulations T and X and observed that the main purpose for margin requirements is to protect the general economy, not individual investors:

> Congress imposed the margin requirements to protect the general economy, not to give the customer a free ride at the expense of the broker. Appendix at A-13.

> [T]he purposes of both regulations (T and X) were aimed at realizing or stabilizing a desirable macro-economic goal of Congress rather than the protection of investors. Appendix at A-25.

cluded that the reasons for allowing private rights of action under Regulation T prior to Regulation X had been seriously undermined by the promulgation of Section 7(f) of the Exchange Act, and Regulation X.[5]

The only circuit court other than the Tenth Circuit which has even discussed the effects of Regulation X upon a private right of action under Regulation T was the Second Circuit Court of Appeals in *Pearlstein v. Scudder & German*, 527 F.2d 1141 (2d Cir. 1975), which involved the remand of the earlier *Pearlstein, supra,* in which the court had recognized a private cause of action under Regulation T. The court stated that a private right of action under Regulation T is "highly questionable" following congressional enactment in 1970 of Section 7(f) and the promulgation of Regulation X in 1971:

> The effect of these developments is to cast doubt on the continuing validity of the rationale of our prior holding. 527 F.2d at 1145, n.3.

Apart from the Second and Tenth Circuits, no other circuit court of appeals has addressed the question of the

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Additionally, it was observed that Congress, knowing that for years a private cause of action had been implied under Regulation T and that by implementing Regulation X the rationale for such private actions would be undermined, could easily have authorized a private remedy yet chose not to do so. In this regard the District Court stated:

> [I]t would seem pretentious for this court to expand an area of federal law so recently considered by Congress by "implying" a private damage action for those guilty of margin violations under the law. Appendix at A-28.

[5]A review of *Pearlstein* and the other cases in which a private action under Regulation T was recognized [See, e.g. *Spoon v. Walston & Co., Inc.*, 478 F.2d 246 (6th Cir. 1973) and *Landry v. Hemphill, Noyes & Co.*, 473 F.2d 365 (1st Cir. 1973), *cert. denied* 414 U.S. 1002 (1973)] reveals that the private action was allowed because the investors were not prohibited from accepting credit in excess of the margin requirements and, being thus free from wrongful conduct, were permitted to assist in deterring brokers from extending cedit illegally. However, whatever the merit of such rationale, it was seriously undermined by the promulgation of Section 7(f) of the Exchange Act, 15 U.S.C. §78g(f) (1970), and by Regulation X which placed the responsibility for compliance with the margin requirements on the investor as well as on the broker. See *S.E.C. v. Packer, Wilbur & Co., Inc.*, 362 F.Supp. 510, 515 (S.D.N.Y. 1973).

effect of Regulation X on a private right of action under Regulation T. All circuit cases cited by the University in its Petition pertain to transactions carried out prior to the promulgation of Regulation X.

Thus, there exists no conflict among the circuit courts of appeal concerning the question which the University seeks this Court to review.

Further, the University's assertion in its Petition that the opinion of the Circuit Court is "in conflict with a growing body of district court cases" (Petition, pp. 8, 11-12) is unmeritorious. A review of the district court cases cited by the University reveals (1) that the facts and allegations presented in those cases are vastly different from those presented in this case, and (2) that the opinion of the Circuit Court is harmonious with, not contrary to, the reasoning and opinions in those cases.

The University cites the following district court cases in support of its Petition: (1) *McNeal v. Paine, Webber, Jackson & Curtis, Inc.*, 429 F.Supp. 359 (N.D. Ga. 1977); (2) *Palmer v. Thomson & McKinnon Auchincloss, Inc.*, CCH Fed. Sec. L. Rep. §96,000 (D. Conn. 1977); (3) *Lantz v. Wedbush, Noble, Cook, Inc.*, 418 F.Supp. 653 (D. Alas. 1976); *Neill v. David A. Noyes & Company*, 416 F.Supp. 78 (N.D. Ill. 1976) and *Newman v. Pershing & Co., Inc.*, 412 F.Supp. 463 (S.D.N.Y. 1975).

The *McNeal*, court agreed with the Circuit Court in this case that the additions of Section 7(f) and Regulation X places in doubt the right of an investor to recover for margin violations of its broker. See 429 F.Supp. at 365. It held, however, that a private right of action under Regulation T might still exist where an investor has been affirmatively misled by his broker into believing that his account is in

compliance with Regulation T and, as a result, suffers tangible losses when his broker sells certain stocks at an unfavorable price in order to comply belatedly with the regulation. See 429 F.Supp. at 365.

There were no allegations in this case that any of the broker-dealers affirmatively misled the University. The holding under *McNeal* would also result in the dismissal of this action. Indeed, the Tenth Circuit distinguished *McNeal* on this same ground and held that *McNeal* was inapplicable for that reason.

Similarly, *Palmer* is distinguished from this case because it involved inexperienced small investors who had suffered damages caused, at least in part, by violations of Regulation T committed by a broker-dealer. Such facts are in sharp contrast to this case where the University's experienced investments officer placed and supervised the University's substantial securities transactions and was well aware of the margin requirements to the point of taking advantage of the time limits thereunder. Further, the court in *Palmer* expressly recognized that the promulgation of Section 7(f) and Regulation X thereunder has, at least, had the effect of requiring an investor to "demonstrate his good faith — that he acted innocently without knowledge that the transaction violated the margin requirements" [Fed. Sec. L. Rep. at 91,496 (footnote omitted)] in order to be permitted to bring a private action under Regulation T.

Likewise, the court in *Newman* recognized that subsequent to the promulgation of Regulation X, the continued validity of *Pearlstein* is questionable and expressly rejected the right of a plaintiff investor to bring a private right of action against a broker-dealer for violating Regulation T absent a showing by the investor that the broker-dealer's offer of illegal credit induced the investor to purchase securities which he otherwise would not have acquired.

Lantz and *Neill* are likewise distinguishable from the present case in that both of those cases contained allegations of plaintiff-investors that defendant-brokers had actively misled the plaintiffs or were otherwise guilty of fraud and deceptive conduct regarding compliance with margin requirements. No such allegations are present in this case. In fact, if such allegations had been present in the present action, the Circuit Court indicates that the result reached may have been different:

> *Neill* . . . is not pertinent (in this case) because the complaint alleged fraud and deceptive conduct. See also *Lantz* . . . . Appendix at A-12.

Thus, there being no conflict between the opinion of the Circuit Court and the other Circuit Courts of Appeal or recent district court decisions, Petitioner's first reason for granting a writ of certiorari in this case is without merit and should be rejected.

B. THE QUESTION PRESENTED IS NOT AN IMPORTANT QUESTION OF FEDERAL LAW WHICH SHOULD BE SETTLED BY THIS COURT.

Petitioner contends that this Court should review the question presented because it presents an important question of federal law which has not been, but should be, settled by this Court. As previously stated, this contention is contradicted by the fact that the Circuit Court's opinion dealing with the question is not in conflict with the decisions of the other circuits and in fact, is in agreement with the Second Circuit, the only other Circuit Court of Appeals to even consider the issue.

The administration of both Regulation T and Regulation X will continue and the Federal Reserve Board will

continue to have the right to seek compliance with both Regulation T and Regulation X.

Nor is Petitioner's assertion that the Federal Reserve Board's participation as *amicus curiae* in the Petition for Rehearing before the Circuit Court on this case elevates the question presented to the status of an important question of federal law. The Federal Reserve Board continues to have the right to seek compliance with Section 7 and the regulations promulgated thereunder and the outcome of the question presented will have no effect upon the Federal Reserve Board in the administration and enforcement of those regulations.

Relying on the Circuit Courts of Appeal to effect uniformity in the interpretation of Section 7 should be encouraged. The question presented in this action has only been reviewed in one Circuit Court of Appeals and the fact that other circuit courts may have an opportunity to review the question, if it is presented again, can in no way harm the public interest.

For these reasons, Petitioner's second reason for granting review of the question presented should also be rejected.

C. UNDER THE CIRCUMSTANCES OF THE PRESENT CASE, THERE IS NO BASIS FOR ANY THEORY UPON WHICH THE UNIVERSITY HAS A RIGHT TO BRING A PRIVATE ACTION AGAINST THE BROKER-DEALERS UNDER REGULATION T.

The question presented must be limited to the facts and circumstances of the present case. These facts as presented to the courts below reveal the activities of a well-educated, experienced investments officer of the University who pur-

chased and sold, with written authorization from the University's Board of Trustees, substantial volumes of securities with the assistance of the broker-dealers. Unfortunately, the investments did not fare well. The University sought to recoup its losses by placing liability on the broker-dealers because of alleged violations of Regulation T.

Under such circumstances, the University has no right to bring a private action against the broker-dealers upon any theory. The District Court noted:

> The University, an institutional investor (and an agency of the sovereign) which must operate under guidelines established by statutes, regulations and rules, engaged itself in a far-flung, wide-ranging investment program in common stocks which it now asserts it had no authority to do. Neither the main purpose of section 7(c) — e.g., ". . . to prevent a recurrence of the pre-crash situation where funds which would otherwise have been available at normal interest rates for use of local commerce, industry and agriculture. . . ." — nor the secondary purpose — e.g., the ". . . protection of the small speculator by making it impossible for him to spread himself too thinly. . . ." — are served by implying a private right of action under the facts of this case. . . . The rationale that argues for implying a private right of action for a financially strong institutional investor under either the primary or secondary purpose of section 7(c) hangs from a thin, fragmented thread. *The court is unaware of any authority under which private civil liability should be implied or sustained in this case.* Appendix at 4-30. (emphasis added).

Furthermore, the District Court recognized that even if a private cause of action existed in favor of the University, Regulation X would provide an *in pari delicto* defense which

would sustain a motion for summary judgment in favor of the broker-dealers:

> Regulation X makes the University equally responsible and liable with the defendants for the alleged margin violations. . . . At best, therefore, the plaintiff's theory is novel, in that it seeks to selectively rescind and be made whole on all its loss transactions while keeping the benefits of its gain transactions. *The court is unaware of any authority which would allow such a favorable remedy to a plaintiff who is equally guilty of violation of the regulation under which liability would be imposed against the defendant.* Neither justice nor reason provide grounds on which to sustain a cause of action for the University's theory under all circumstances of this case. Appendix at A-30 & A-31. (emphasis added).

The Circuit Court's opinion is likewise based on and limited to the facts of the present action in which a private cause of action under Regulation T on behalf of the University would not be permitted on any theory.

CONCLUSION

For the reasons set forth above, the Respondent respectfully submits that the University has failed to advance any reasons why this Court should review the question presented in this case. The Petition for Writ of Certiorari should be denied.

Respectfully Submitted,

SNOW, CHRISTENSEN
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IN THE

Supreme Court of the United States

October Term, 1977

No. 77-99

UTAH STATE UNIVERSITY OF AGRICULTURE AND APPLIED SCIENCE,

Petitioner,

v.

BEAR, STEARNS & CO., et al.,

Respondents.

BRIEF OF RESPONDENT BLYTH EASTMAN DILLON & CO. IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

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Respondent Blyth Eastman Dillon & Co. respectfully submits its Brief in Opposition to the Petition for a Writ of Certiorari herein.

QUESTION PRESENTED

Whether, in the absence of (1) allegations of scienter and (2) lack of fault by the plaintiff as defined by Regulation X of the Federal Reserve Board, extensions of credit by a broker to its customer in violation of Regulation T of the Federal Reserve Board give rise to a private cause of action or an absolute liability remedy.

STATEMENT OF THE CASE

The presentation of a single petition concerning eight companion cases, each standing on its separate facts renders the Statement of the Case presented by Petitioner Utah State University of Agriculture and Applied Science [the University] so misleading, particularly as to Respond Blyth Eastman Dillon & Co. [BEDCO], that a separate statement is both necessary and appropriate.

The complaint alleges that the University purchased stock through BEDCO, acting as its broker, pursuant to formal resolutions of the University's Institutional Council (its governing board) (A-2). The resolution, delivered to BEDCO and retained in its files, provided that the University's investment officer, Donald Catron [Catron], a sophisticated accountant, businessman and former securities salesman (A-3), had authority to act for the University "until written notice of the revocation hereof shall be delivered to" BEDCO (A-2).

Pursuant to the resolution the University established a cash account with BEDCO in 1971 and in 1972 the University established purchase against delivery [PAD] accounts with BEDCO. Pursuant to the PAD account, payment by the University, which otherwise would be due within seven days of the date of purchase,[1] could be delayed until the securities were actually delivered, provided the securities were delivered within thirty-five days of purchase date and the University paid upon delivery.[2] Catron instructed BEDCO to make deliveries to one of the University's banks in Logan, Utah.

In the Spring of 1972, the Utah State Auditor's office notified Catron that an audit would be made on the University's investment program. That prompted Catron to engage in a series of transactions which are the subject of this action, in which he sold stock through one broker and immediately repurchased the same stock utilizing another broker. The effect of this device, when employed with the PAD accounts, was that the University received immediate payment for the stock sold but did not have to pay for the stock bought until its delivery (A-3), thus improving the appearance of its cash flow over a short period of time.

[1] 12 C.F.R. Part. 220, cited at A-10.

[2] 12 C.F.R., §220.4(c) (5).

The University then instructed Catron to stop purchasing securities on its behalf, but did not revoke his authority with BEDCO or any other broker until four months later. Many of the transactions complained of fell within that four month period.

With respect to all purchase transactions in which BEDCO was involved, *all* securities were delivered for payment within thirty-five days of the trade date. The University correctly states that, in some instances, it failed to pay for these securities upon delivery or within the thirty-five day period, contrary to its agreement in establishing the PAD account.

With respect only to those securities so purchased which eventually declined in value, the University filed suit against BEDCO contending that BEDCO had violated Section 7(c) of the Exchange Act [15 U.S.C. §78g(c)] and Federal Reserve Board Regulation T thereunder (12 C.F.R. part 220) by failing to liquidate the University's account at the end of the thirty-five day period in those instances where the University had failed to make timely payment. The complaint did not allege "scienter" or any intentional misconduct, or acts tantamount to fraud, or that the University did not have knowledge of or consent

to the transactions. Neither does the complaint allege that the violations of Regulation T "caused" either the transactions or any eventual losses or that the University would not have engaged in the transactions had Regulation T been complied with. The United States District Court for the District of Utah granted BEDCO's motion to dismiss for failure to state a claim upon which relief could be granted and the Court of Appeals for the Tenth Circuit affirmed.

REASONS FOR DENYING THE WRIT

These cases center upon the interface of Sections 7(c) and (f) of the Securities Exchange Act of 1934, [15 U.S.C. §78g(c) and (f)], and Federal Reserve Board Regulations T (12 C.F.R. part 220) and X (12 C.F.R. part 224) promulgated, respectively, thereunder.

Section 7(c) of the Exchange Act and Regulation T require that a broker liquidate PAD accounts such as those established by the University if payment is not made within thirty-five days of purchase. In 1970, over Justice Friendly's vigorous dissent, Regulation T was held to impliedly create a civil remedy for damages in favor of a customer for a broker's negligent violation of the regulation, even where the customer was at fault.[3] *Pearlstein v. Scudder & German*, 429 F.2d 1136 (2d Cir. 1970), *cert. denied*, 401 U.S. 1013 (1971) [*Pearlstein I*].

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[3]Judge Waterman, speaking for the *Pearlstein I* majority answered the objection that the plaintiff should be denied recovery because he was *in pari delicto* with the observation that:

> the federally imposed margin requirements forbid a broker to extend undue credit but do not forbid customers from accepting such credit. This fact appears to indicate that Congress has placed the responsibility for observing margins on the broker . . .

That holding provoked Judge Friendly's vigorous dissent in which he recognized that the purpose of Regulation T was not to protect individual investors but rather the economy and that an implied right of action created more problems than it solved.

Congress responded to the apparent inequity of *Pearlstein I* by enacting Section 7(f) [15 U.S.C. § 78g(f)], making it unlawful for a customer to *accept* proscribed extensions of credit and Federal Reserve Board Regulation X was promulgated thereunder specifying generally that it was illegal for a customer to obtain credit which did not conform to the provisions of Regulation T.

The enactment of Section 7(f) prompted the Second Circuit to disavow its *Pearlstein I* holding in *Pearlstein v. Scudder & German*, 527 F.2d 1141, n.3 (2d Cir. 1975) [*Pearlstein II*]:

> [T]he addition of Section 7(f) to the Exchange Act of 1970, 15 U.S.C. §78g(f), as well as the promulgation by the Federal Reserve Board of Regulation X, 12 C.F.R. §224 (1975), have now made it unlawful to obtain credit in violation of the margin requirements. *The effect of these developments is to cast doubt upon the continued viability of the rationale in our prior holding.* (emphasis added)

The University in effect urges this Court to ignore the enactment of Section 7(f) and adopt the discarded authority of *Pearlstein I*.

The representations at Pet. 4 that the Court of Appeals held that "no private cause of action exists for violations of Regulation T" and at Pet. 8 that "[t]he Opinion below is not clear whether the Court merely refused to . . . [allow] private causes of action to enforce Regulation T . . . or whether the Court's holding was based on the 1970 amendment and Regulation X promulgated under the amendment" are misleading, for the Court of Appeals clearly held "that in an appropriate case there may be an implied cause of action for private redress for violation of [National Association of Securities Dealers] or

exchange rules" (A-8-9) or under Rule 10b-5 (17 C.F.R. §240.10b-5) if there is "scienter" as defined in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, *reh. denied* 425 U.S. 986 (1976). While this holding was not expressly applied to Regulation T its application to the general fraud provisions leaves the Court's intent sufficiently clear. Moreover, the Court's inclination to apply this holding to an appropriate Regulation T claim is made explicit by its distinguishment of two district court cases[4] imposing liabilities based upon Regulation T as "not pertinent because the complaint[s] alleged fraud and deceptive conduct" (A-12).

In light of the complaint's failure to allege the elements of scienter required by this Court in *Hochfelder*, and considering (as demonstrated hereafter) that *every* court which has considered the Section 7(c) - 7(f) interface has applied an equal fault standard, the University has not advanced an issue worthy of review. Factually this case does not present the issue posed and, in any event, the question is premature until such time, if ever, the lower federal courts announce conflicting interpretations of the Section 7(c) - 7(f) interface.

I. THE ISSUE ADVANCED IS NOT RIPE FOR REVIEW

A. *The University Concedes That There is no Conflict Among the Circuits.*

The University correctly concedes that no other Court of Appeals has yet considered the Regulation T — Regulation X interface (Pet. 11, 16). Thus, the University urges this Court to consider an imaginary conflict on

[4]Lantz v. Wedbush, Noble, Cooke, Inc., 418 F. Supp. 653 (D. Alas. 1976); Neill v. David A. Noyes & Co., 416 F. Supp. 78 (N.D. Ill. 1976).

which the jury is not yet in. This Court should address itself to real issues and grant the circuits an opportunity to explore a conflict, should it ever appear. R. STERN & E. GRESSMAN, SUPREME COURT PRACTICE §4.3 at p. 154 (4th ed. 1969).

B. *No Issue of Overriding Importance is Presented.*

The University's assertion that this case presents issues meriting review rests on its two stage assertions at Pet. 5-9 that (1) other courts have held that Section 7 and Regulation T "*may* be the basis for a private civil action for damages" (Pet. 5, emphasis added) and (2) Section 7(f) and Regulation X, which removed the underpinning for *Pearlstein I*, do not make an "innocent mistake" by a borrower a violation of the statute and regulation (Pet. 8). As to both propositions, even if correctly stated, the opinion of the Court of Appeals is in complete accord.

The Court of Appeals carefully examined and implemented this Court's *Hochfelder* decision, and left open the question of liability under Regulation T in cases alleging "fraud and deceptive conduct." Thus, the Court of Appeals for the Tenth Circuit is in line with those courts holding that the statute and rule *may* be the basis for liability, in a proper case.

The Court of Appeals did not reject an "innocent mistake" claim. To the contrary, it took special note of the high degree of fault that the University was guilty of: resolutions confirming authority on its investment officer that were illegal under state law (A-2-3), that "USU seeks to take advantage of its own wrongful acts" (A-9), "that USU [n]ever complained to any broker because of delay in delivery and payment" (A-10) and that the Uni-

versity did not "allege that any particular stock or stocks . . . could have been disposed of without loss" (A-11).

Therefore, contrary to the contrived argument of the University, this case presents no conflict with this Court's time honored implied remedy doctrine announced in *J. I. Case Co. v. Borak*, 377 U.S. 426 (1964). It merely implements the recent pronouncements of this Court requiring that "causation," *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972), and "scienter," *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, *reh. denied* 425 U.S. 986 (1976) be alleged and proven.

C. *No Relevant District Court Decision is Inconsistent With the Tenth Circuit's Holding.*

The University argues that the decision of the Court of Appeals herein is inconsistent with a "growing body" of district court determinations (Pet. 11). In fact, no post-Section 7(f) decision advanced by the University has afforded a customer relief against a broker absent a showing of (1) the broker's purposeful misconduct and (2) the customer's lack of fault.

Cases dealing with purposeful misconduct include *Lantz v. Wedbush, Noble, Cooke, Inc.*, 418 F. Supp. 653, 655 (D. Alas. 1976) (Pet. 11, 15), where the Court observed that the plaintiff contestably "alleges that defendant actively mislead plaintiff," and *Neill v. David A. Noyes & Co.*, 416 F. Supp. 78, 80 (N.D. Ill. 1976) (Pet. 11), where an action for damages under Section 7(c) was permitted where "fraud on the part of the broker" was alleged and where "the plaintiffs were . . . innocent customers of the broker-defendant." *Newman v. Pershing & Co., Inc.*, 412 F. Supp. 463, 468 (S.D.N.Y. 1975) (Pet. 11), specifically required an allegation of scienter.

Cases dealing with the customer's fault include *Lantz*, which recognized an *in pari delicto* defense under Section 7(f), and *Palmer v. Thomson & McKinnon Auchincloss, Inc.*, CCH Fed. Sec. L. Rep. ¶96,000 (D. Conn. 1977) (Pet. 8, 11, 12, 14-16), where the court permitted an action under Section 7(c) for an innocent, unknowing investor against a broker who knowingly "attempts to circumvent Regulation T." ¶19,000 at 91,496-97, fn. 20.

In *McNeal v. Paine Webber, Jackson & Curtis, Inc.*, 429 F. Supp. 359, 363 (N.D. Ga. 1977), on which the University places principal reliance, (Pet. 8, 11, 16), the court failed to dismiss plaintiff's Section 7 claim because it was alleged that the broker "affirmatively deceived" the plaintiff. That holding is consistent with this Court's decision in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, *reh. denied* 425 U.S. 986 (1976) and not inconsistent with the decision herein.

No case cited by the University supports the expansive interpretation requested of this court. Lower court conflict is imagined by the University in its hope to make a fictional issue real.

D. *The Decision Below is not Inconsistent with Federal Reserve Board Policy Statements.*

The University's reference to the Federal Reserve Board question and answer booklet (Pet. 9-11) assumes that the manual is either authoritative or exhaustive. In any event, the language relied upon is inconsistent with the University's position.

The manual correctly states that (1) "contracts made in violation of regulations issued thereunder [are] *void as to the rights of the violator*" (Pet. 10) (emphasis added) and (2) that "[t]he party *not responsible for the viola-*

tion may . . . in a proper case, sue for damages" (Pet. 10 emphasis added). On both points the courts below found against the University's position. The District Court found that the University had violated Regulation X and the Court of Appeals acknowledged the existence and operation of the scheme employed by the University in connection with such violations (A-31, A-3).

If a broker, with the intent to manipulate, deceive or defraud, knowingly violates the requirements of Regulation T to the detriment of an innocent and unknowning customer a civil damage action undeniable may arise under Section 10(b) of the Exchange Act [15 U.S.C. §78j(b)], and Rule 10b-5 promulgated thereunder (17 C.F.R. §240.10b-5). *Ernst & Ernst v. Hochfelder,* 425 U.S. 185, *reh. denied* 425 U.S. 986 (1976). The University, far from being an innocent and unknowing victim, was engaged in a scheme having the purpose and effect of circumventing the requirements imposed upon it by Regulation X.

II. THE FACTS OF THIS CASE ARE INAPPROPRIATE TO RESOLVE THE ISSUE ADVANCED

The question boldly presented by the University (Pet. 3) is one which neither can nor should be decided in any consideration of this case. If the issue ever warrants consideration it should arise from facts which disclose, (1) that a broker failed timely to deliver purchased securities, (2) that in so doing, the broker acted with scienter, (3) that an innocent and unknowing customer was damaged by the broker's manipulative acts. None of these elements are involved in this case.

First, the University does not claim that BEDCO failed to *deliver* any securities within the prescribed thirty-

five day period. The violation of Regulation T alleged, rather, is that *the University failed to pay timely upon delivery* and that BEDCO should be held responsible for the University's default.

Second, the University does not allege "scienter" or any purposeful misconduct by BEDCO, but seeks to reinstate the discarded strict liability concept of *Pearlstein I,* in disregard of the subsequent enactment of Section 7(f).

Third, far from being an innocent customer, the District Court found the University to have knowledge of and *in pari delicto* with respect to the acts alleged. (A-30, 31). The Court of Appeals also acknowledged that the University was engaged in a manipulative scheme designed to improve its apparent cash flow (A-3).

The issue advanced cannot be resolved in a factual vacuum. A definitive pronouncement can only arise from consideration of a case where the issue is more appropriately presented.

CONCLUSION

The petition presents no conflict between the Circuits or issues of overriding national concern. Moreover, the issue presented cannot be resolved on the facts of this case. Accordingly, the petition should be denied.

Respectfully submitted,

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